

Fair To Whom? Examining Delaware's Fair Summary Standard

Law360, New York (March 22, 2017, 11:23 AM EDT) -- Under Delaware's corporate-friendly disclosure regime, shareholders are "entitled only to a fair summary of a financial advisor's work."^[1] And regardless of what one deems to be a "fair summary," under Delaware law directors are not required to provide shareholders with the financial data necessary to make an independent determination of fair value.^[2] This begs the question — why not? To date, no one has offered a persuasive answer.

The general response is the "need to avoid rules of disclosure that simply inflate the already-weighty proxy statements that stockholders receive."^[3] This excuse for withholding potentially valuable financial information from shareholders does not hold up under scrutiny. It is true that proxy statements are lengthy documents. But adding a few tables of financial data certainly does not threaten to suddenly "bury" shareholders in information. Indeed, even critics of disclosure-based litigation have acknowledged that the issue most central to shareholders assessing a merger is whether they are receiving fair value for their stock.^[4] Yet, as a result of recent developments in Delaware law, retail investors are often left with no recourse to obtain fair consideration in connection with unfair corporate transactions.



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The Lack of an Appraisal Remedy for "Small" Shareholders

First, this past year the Delaware Legislature limited the ability of shareholders who hold less than \$1 million or 1 percent of a company's stock to seek appraisal.^[5] The reform to Delaware's appraisal statute further cements appraisal as a remedy that only wealthy shareholders can pursue. Yet, Delaware's fiduciary standards allow directors to evade liability even in cases where they grossly miscalculate a company's value, leaving smaller shareholders without any remedy.^[6] As an attorney at a prominent defense firm noted in a Wall Street Journal article titled "Is Delaware Law Rigged Against the Small Shareholder?":

Retail shareholders are generally left high and dry unless there's an obvious procedural error, while hedge funds and other sophisticated investors can afford to navigate the complex appraisal process. And the small shareholder arguably gets hit twice: Some have suggested that buyers in such deals may pay less to cover a potential recovery in an appraisal ... If the Delaware courts are going to conduct an independent financial analysis of the fairness of the price, the results should benefit all shareholders.^[7]

A well-known law professor made a similar argument in a New York Times article last year, writing, “[t]he \$1 million minimum seemingly unfairly knocks out small shareholders but not professional hedge funds. There should be a remedy for a small shareholder who feels ill-treated.”[8] Delaware’s courts and Legislature have yet to respond to these calls for protections for smaller shareholders, however.

The Irrebuttable Business Judgment Rule

Second, in a wave of recent opinions, Delaware courts have held that the business judgment rule irrebutably applies in cases challenging transactions approved by shareholders on a purportedly “fully informed” basis, even if the transaction would otherwise have been subject to entire fairness review because of director conflicts.[9]

Plaintiffs lawyers and academics have argued that making the determinative issue on a motion to dismiss whether or not shareholders are “fully informed” when voting on a transaction is inequitable given the significant information asymmetry hurdles shareholders face.[10] Yet, this criticism has been rejected by the Delaware Court of Chancery, under the guise that the supposedly “low” thresholds for obtaining expedited discovery and succeeding on a books and records action sufficiently allow shareholders to obtain information and investigate claims. However, Delaware courts often pay lip service to their “plaintiff-friendly” standards, and then go on to apply a much more stringent standard.[11] *Infra*.

Ironically, by making it exceedingly difficult to defeat a motion to dismiss in merger litigation “even in the context of difficult fact situations” for defendants,[12], Delaware courts have strengthened the case for approving the “disclosure-only” settlements they have recently criticized. Disclosure-based relief can hardly be deemed insufficient if no other form of relief can realistically be obtained. And there is little risk in releasing merger-related claims in exchange for disclosures if such claims are now largely unviable under Delaware law. Simply put, a release of worthless claims is not really much of a release at all. Further, as the New York Appellate Division recognized in its recent *Gordon v. Verizon Communications Inc.* opinion addressing Delaware’s *Trulia*[13] standard, disclosure-based settlements continue to serve as “a useful tool in remedying corporate misfeasance” and “a more balanced approach in evaluating non-monetary class action settlements” is necessary.[14]

The Increasingly Stringent Materiality Standard

The third trend that warrants scrutiny is Delaware’s increasingly rigorous materiality standard. While Delaware courts profess to apply the U.S. Supreme Court’s materiality standard, in practice they apply a much more stringent one. As a leading scholar on the issue of corporate disclosure wrote in a thorough law review article on the issue published in 2003:

The interpretation of materiality by Delaware courts lies in sharp contrast to that used in the federal system. Although both rely on an identical definition of materiality, a comparison of cases suggests that, while state courts use the same terminology, they rely on a far more restrictive interpretation. As a result, shareholders do not always receive information that federal courts would deem “important” to a “reasonable investor.”[15]

This article focused its analysis on two categories of disclosures: information regarding the adequacy of the offer price in a business sale, and information regarding conflicts of interest faced by directors and officers.[16] With respect to valuation information, the article noted: “Delaware courts decline to find as material categories of information suggesting the inadequacy of the offering price. They do not require the disclosure of

additional, higher-priced offers, alternative formulas used to compare value, even if presented to the board, or other valuations in the company's possession.”[17]

To those wondering if things have changed in recent years, they have — the standard has become even more exacting. Indeed, even the defense bar has taken note of Delaware's increasingly stringent materiality standard; as a partner at a leading defense firm recently noted, the Court of Chancery has begun applying a “stricter standard for materiality of disclosure” and “has not viewed as material what it has characterized as ‘details’ regarding the sale process, including with respect to bankers’ analyses, that, in our view, in the past might well have been deemed material.”[18]

Simply put, Delaware courts should stop professing to apply the U.S. Supreme Court's materiality standard, because they don't. And to those who question what good more financial data would do for retail investors that individually lack the voting power necessary to halt a transaction, the goal from their perspective should be to get enough information to the market so that more sophisticated shareholders can carefully scrutinize and publicly oppose bad deals. Just recently, a shareholder in Skullcandy Inc. that owned a mere 0.24 percent of the company issued a press release that urged fellow shareholders to reject a tender offer he believed unfairly valued the company, and called upon the company to provide additional information regarding its financials that could “significantly benefit shareholders.”[19] Had shareholders pressed a disclosure claim in Delaware, however, they almost certainly would have been shot down. Ultimately, another bidder made a superior offer to acquire the company for an extra \$20 million. In an era when instantaneous communication to masses of shareholders can be easily accomplished, it is not unrealistic to expect that similar situations would unfold more often if shareholders could force the disclosure of more internal financial data from companies and their bankers.

Conclusion

When you couple these recent developments in Delaware law, retail investors are often left with no recourse to obtain truly fair consideration for their shares in connection with unfair mergers; they can't determine fair value from the company's U.S. Securities and Exchange Commission filings, they have no independent appraisal rights, and they have virtually no chance of defeating a motion to dismiss in an action for breach of fiduciary duty.

Those concerned about shareholders' rights should continue to fight in federal court, where shareholders can obtain damages in connection with inadequate disclosure. As recent articles have reported, merger litigation in federal court asserting claims under Section 14 of the Exchange Act has increased in the past year in light of the significantly pro-defendant shifts in Delaware law.[20] Plaintiffs lawyers should alert federal courts to the fact that Delaware courts apply a much stricter materiality standard than that set forth by the U.S. Supreme Court, despite their contention to the contrary. The federal securities laws were a direct response by Congress to calls for increased federal regulation in light of lax state laws regulating corporate behavior.[21] While Congress has generally declined to substantively regulate corporate transactions, it responded to calls for federal intervention by mandating disclosure through the federal securities laws.[22] In other words, the disclosure requirements of the federal securities laws are supposed to serve as a counterbalance for shareholders against Delaware's corporate-friendly fiduciary standards, and Delaware's materiality case law should serve as the ceiling for materiality in federal courts, not the floor.

In sum, while Delaware's “fair summary” disclosure standard was initially praised by shareholder lawyers, recent opinions raise a legitimate question — when Delaware's courts say shareholders are entitled to a “fair summary,” whose perception of “fairness” do they have in mind? Recent cases suggest that fairness in Delaware is judged from the corporation's perspective, not the shareholders'.

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[1] *Dent v. Ramtron Int'l Corp.*, No. 7950-VCP, 2014 Del. Ch. LEXIS 110, at *35 (Del. Ch. June 30, 2014) (“stockholders are entitled only to a fair summary of a financial advisor’s work, not the data to make an independent determination of fair value.”).

[2] *Id.*

[3] *In re Staples S’Holders Litig.*, 792 A.2d 934, 954 (Del. Ch. 2001).

[4] Jill E. Fisch, Sean J. Griffith and Steven Davidoff Solomon, *Confronting the Peppercorn Settlement in Merger Litigation: An Empirical Analysis and a Proposal for Reform*, 93 *Tex. L. Rev.* 557, 609 (February 2015).

[5] 8 Del. C. § 262(g).

[6] See Ronald Barusch, *Dealpolitik: Is Delaware Law Rigged Against the Small Shareholder?*, *The Wall Street Journal* (June 7, 2016), <http://blogs.wsj.com/moneybeat/2016/06/07/dealpolitik-is-delaware-law-rigged-against-the-small-shareholder/>.

[7] Barusch, *supra* note 6.

[8] Steven Davidoff Solomon, *Delaware Effort to Protect Shareholders May End Up Hurting Them*, *N.Y. Times* (May 24, 2016), <https://www.nytimes.com/2016/05/25/business/dealbook/delaware-effort-to-protect-shareholders-may-end-up-hurting-them.html>.

[9] *Chester Cnty. Ret. Sys. v. Collins*, No. 12072-VCL, 2016 Del. Ch. LEXIS 197, at *4 (Del. Ch. Dec. 6, 2016) (“T]he effect of disinterested stockholder approval of the merger is review 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.”).

[10] E.g., Miles D. Schreiner, *The Delaware Courts’ Increasingly Laissez Faire Approach to Directorial Oversight*, *Harvard Law School Forum on Corporate Governance and Financial Regulation* (July 20, 2016); J. Robert Brown Jr., *Speaking with Complete Candor: Shareholder Ratification and the Elimination of the Duty of Loyalty*, 54 *Hastings L.J.* 641, 643 (2003) (“Informed shareholders must have all material information when consenting to the self-dealing. In practice, however, they often do not. Delaware courts repeatedly consider immaterial categories of information among the most important to shareholders in deciding how to vote. As a result, disinterested shareholders in reality are not informed at the time of ratification.”).

[11] See, e.g., Jay Lefkowitz, Matthew Solum and Adam Humann, *Expedition Standards Tighten In M&A Litigation*, *Law 360* (July 7, 2016), <http://www.law360.com/mergersacquisitions/articles/814539/expedition-standards-tighten-in-m-a-litigation>; Megan D. McIntyre, *The Stockholder’s Statutory Right to Inspect*

Corporate Books and Records, Grant & Eisenhofer PA, 3, 2010, http://www.gelaw.com/wp-content/uploads/2015/02/Books_and_Records.pdf (noting Delaware courts have held shareholders failed to meet the “credible basis” standard for succeeding on a books-and-records action “even in circumstances that would appear relatively egregious to the average stockholder.”).

[12] Gail Weinstein and Philip Richter, 2017: Where Things Stand — Appraisal, Business Judgment Rule and Disclosure, Harvard Law School Forum on Corporate Governance and Financial Regulation (Feb. 28, 2017), <https://corpgov.law.harvard.edu/2017/02/28/2017-where-things-stand-appraisal-business-judgment-rule-and-disclosure/>.

[13] *In re Trulia Inc. Stockholder Litig.*, 129 A.3d 884 (Del. Ch. 2016).

[14] *Gordon v Verizon Communications Inc.*, 2017 N.Y. App. Div. LEXIS 740, 2017 NY Slip Op 00742, 46 N.Y.S.3d 557, at *10, *14 (N.Y. App. Div. 1st Dep’t 2017).

[15] *Brown*, supra note 10, at 643; see also J. Robert Brown Jr., *The Regulation of Corporate Disclosure* §19.07 (Wolster Kluwer 4th ed. 2016) (“Courts in Delaware rely on the federal standard for materiality. Nonetheless, they go to great lengths to find seemingly critical information immaterial.”); *Gordon v. Verizon Communications Inc.*, 2017 N.Y. App. Div. LEXIS 740, *27 (1st Dep’t Feb. 2, 2017) (noting Delaware’s materiality standard is inconsistent with New York’s).

[16] *Brown*, supra note 10, at 643.

[17] *Id.*

[18] Weinstein, supra note 12.

[19] *Shareholder and eFin Founder, Derek Capo, Issues Open Letter to Skullcandy Shareholders*, Business Wire (July 8, 2016), <http://www.businesswire.com/news/home/20160708005779/en/Shareholder-eFin-Founder-Derek-Capo-Issues-Open>.

[20] Steven Davidoff Solomon, *The Shifting Tides of Merger Litigation*, Harvard Law School Forum on Corporate Governance and Financial Regulation (March 1, 2017), <https://corpgov.law.harvard.edu/2017/03/01/the-shifting-tides-of-merger-litigation/>.

[21] *United States v. Siegel*, 717 F.2d 9, 23-24 (2d Cir. 1983).

[22] *Siegel*, supra note 21, 717 F.2d at 24; see also J. Robert Brown Jr., *The Irrelevance of State Corporate Law in the Governance of Public Companies*, 38 U. Rich. L. Rev. 317, 335-337 (2004).