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Latham & Watkins Securities Litigation & Professional Liability

October 6, 2015 | Number 1880

Business Judgment Rule Applies to Merger Approved by Informed, Disinterested Stockholders

Delaware Supreme Court's ruling provides additional grounds for dismissal in post-closing stockholder litigation regarding mergers that are not subject to entire fairness review.

Introduction

Clarifying a long-standing debate, the Delaware Supreme Court has ruled that if a merger is not subject to "entire fairness" review, a fully-informed, uncoerced vote of the disinterested stockholders will invoke the protections afforded by the business judgment rule, rather than subjecting the transaction to review under the "enhanced scrutiny" of *Revlon* or *Unocal*. The decision is likely to have far-reaching implications for the almost universal shareholder litigation that today accompanies public company merger transactions.

Court of Chancery Dismisses Complaint

The case involved a stock for stock merger in which KKR & Co., LLP (KKR) acquired the stock of KKR Financial Holdings LLC (Financial Holdings). Plaintiffs alleged that the transaction was subject to "entire fairness" review because KKR was a de facto controlling shareholder. The Court of Chancery rejected that argument because KKR had neither the level of stock ownership nor other indicia of control sufficient to confer that status; Financial Holdings' independent board was free to exercise its judgment in determining whether to accept the proposed merger transaction.

Alternatively, plaintiffs argued that the transaction was subject to heightened scrutiny under *Revlon*. Defendants argued that *Revlon* did not apply, and that even if it did: (1) the claims were subject to exculpation under the company's charter; (2) the transaction was approved by an independent board majority; and (3) the transaction was approved by a fully-informed, uncoerced vote of the stockholders. The Court of Chancery ruled that *Revlon* did not apply, but also agreed with the defendants that even if it did, the fully-informed, uncoerced stockholder vote in favor of the merger subjected the transaction to review under the business judgment standard of review, rather than the heightened *Revlon* scrutiny. Because the complaint alleged nothing that could violate the business judgment rule, the Court of Chancery dismissed the complaint.

Delaware Supreme Court Affirms

The Supreme Court agreed that the transaction was not subject to entire fairness review for the same reasons the Court of Chancery found. The Supreme Court did not reach the question of whether *Revlon* applied, because "it does not matter" — even if *Revlon* did apply, "the effect of the uncoerced, informed stockholder vote is outcome-determinative" because it makes the transaction subject to review only under the business judgment standard.

The Supreme Court's decision resolved a long-standing debate about its ruling in *Gantler v. Stephens*. In *Gantler*, the Supreme Court found that a corporate action could only be effectively "ratified" by a

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stockholder vote if the stockholders were specifically asked to do so. Plaintiffs had argued that *Gantler* overruled earlier cases finding that a stockholder vote to approve a merger rendered the transaction subject to business judgment review, because the stockholders were not specifically asked to ratify any *Revlon* breach. The Court of Chancery and the Supreme Court both rejected that interpretation of *Gantler*. In agreeing with the Court of Chancery, the Supreme Court clarified that *Gantler* involved only the narrow issue of "ratification" and did not address the effect of a legally required stockholder vote on the standard of review to be applied in litigation challenging the merger. "Had *Gantler* been intended to unsettle a long-standing body of case law," the Supreme Court reasoned, "the decision would likely have said so."

The Supreme Court also cited strong policy concerns to support this outcome. It first noted that *Revlon* (and *Unocal*) "are primarily designed to give stockholders and the Court of Chancery the tool of injunctive relief to address important M&A decisions in real time, before closing." Those cases "were not designed with post-closing money damages claims in mind," and their standards "do not match the gross negligence standard for director due care liability under Van Gorkom" — a remedy that is rarely available in any case due to exculpatory charter provisions.

More importantly, the Supreme Court noted that this doctrine "applies only to fully-informed, uncoerced stockholder votes," and the business judgment rule therefore would not apply if "troubling facts regarding director behavior" that would have been material to the stockholders were not disclosed.

The Supreme Court further observed that when a transaction is not subject to entire fairness review, Delaware's long-standing policy has been to avoid the uncertainties of "judicial second-guessing" when the stockholders have had a free and informed chance to decide for themselves. Indeed, "the core rationale of the business judgment rule" is that "judges are poorly positioned to evaluate the wisdom of business decisions and there is little utility in having them second-guess the determination of impartial decision-makers with ... an actual economic stake in the outcome."

Practical Implications

The KKR decision could significantly impact how shareholder litigation challenging public company mergers is conducted going forward. First, the decision will place an even higher premium on ensuring full and accurate disclosures in advance of the stockholder vote, because the downsides of such disclosure will be far outweighed by the benefit of invoking business judgment rule review (which almost always results in dismissal).

The decision should also affect the calculus for plaintiffs in deciding whether to incur the risk and expense of pursuing post-closing damages claims. If the plaintiff cannot assert a viable disclosure claim, or challenge the vote as coercive, even a defective merger process will likely not result in a money judgment once the transaction has been approved. The *Revlon* claim will need to be litigated at the preliminary injunction stage, or not at all.

Going forward, defendant corporations and directors should have more leverage in dealing with merger litigation because of the increased risk plaintiffs face of dismissal. However, here is always the risk that the more expansive discovery that takes place in post-closing damages litigation casts doubt on the sufficiency of the disclosures and thus brings *Revlon* scrutiny back into play.

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