

# Three decisions consider effect of stockholder approval on challenged transactions

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## **C&J decision**

## **Auspex decision**

## **Basho decision**

## **Comment**

In August 2016 three members of the Delaware Court of Chancery rendered decisions over three consecutive days considering the impact of stockholder votes on challenged corporate transactions. All three cases involved post-transaction claims that board members had breached their fiduciary duties during the deal process, notwithstanding the fact that the transactions at issue had received stockholder approval.

## **C&J decision**

In *City of Miami General Employees' and Sanitation Employees' Retirement Trust v Comstock (C&J)* (1) a former stockholder of C&J Energy Services, Inc filed suit seeking damages for breaches of fiduciary duty against C&J's directors following C&J's merger with a subsidiary of Nabors Industries Ltd. The defendant directors were alleged to have been improperly influenced by the prospect of continued employment or significant compensation, and thereby breached their duty of loyalty in approving the transaction. The plaintiff also alleged that C&J had made inadequate disclosures about the proposed transaction and asserted claims against Nabors and the financial adviser to C&J's special committee for aiding and abetting the breach of fiduciary duty.

After rejecting the plaintiff's disclosure claims on the basis that the disclosures were accurate and the alleged omissions immaterial, Chancellor Bouchard then considered the impact of the C&J stockholder vote on the breach of fiduciary duty claim in light of the Delaware Supreme Court's 2015 decision in *Corwin v KKR Fin Holdings LLC*. (2) *Corwin* held that:

*"the business judgment rule is invoked as the appropriate standard of review for a post-closing damages action when a merger that is not subject to the entire fairness standard of review has been approved by a fully informed, uncoerced majority of the disinterested stockholders."*(3)

However, rather than finding that stockholder approval necessarily cleansed the C&J merger, Bouchard considered whether the plaintiff adequately "rebut[ted] the business judgment presumption that the board acted loyally". The court ultimately rejected the plaintiff's attempt to trigger an entire fairness review, concluding that the prospect of future board membership was "wholly insufficient" to establish that the board was interested, and that the plaintiff had not adequately alleged that C&J's chief executive officer had intentionally deceived the board to further his own self-interest. The Delaware Supreme Court later affirmed *C&J* on appeal in a two-page order without addressing Bouchard's application of *Corwin*.

## **Auspex decision**

Vice Chancellor Slight's decision one day later in *Larkin v Shah (Auspex)*(4) took a broader view of *Corwin*. *Auspex* involved a challenge by former shareholders to the 2015 all-cash sale of Auspex

## AUTHORS

[C Thomas Brown](#)



[Gregory Demers](#)



Pharmaceuticals, Inc to Teva Pharmaceuticals Industries, Inc for \$3.5 billion. The plaintiffs alleged that:

- two venture capital firms that collectively controlled 23.1% of Auspex's stock and three of nine board seats acted as a controlling shareholder block; and
- a majority of directors who approved the deal had disabling conflicts of interest, including affiliation with the venture capital firms and the enticement of post-merger employment offers.

The court dispensed with the plaintiffs' controlling shareholder allegation, holding that they had failed to adequately allege that the venture capital board designees exercised any form of actual control over the rest of the board. The court then turned to the impact of stockholder approval on the breach of duty claims.

Applying *Corwin* to those claims, Slight concluded that, in the absence of a controlling stockholder that extracted personal benefits from the transaction, "the 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". Stockholder approval then "extinguishes all challenges to the merger except those predicated on waste". As a result, unlike *C&J*, the court in *Auspex* concluded that it need not reach the plaintiffs' allegations about disabling board conflicts because stockholder approval triggered the "irrebuttable" business judgment rule and extinguished the plaintiffs' duty of loyalty claim.

### ***Basho* decision**

A third decision from the Court of Chancery just one day after *Auspex* was issued also considered a similar issue but reached yet another result. In *Basho Technologies Holdco B, LLC v Georgetown Basho Investors, LLC*(5) the former chair of Basho Technologies, Inc, along with several Basho investors, brought suit against certain directors and officers of the company for alleged breach of fiduciary duty related to a 2014 preferred stock financing transaction, which had received board and stockholder approval. The plaintiffs claimed that the financing transaction was precipitated by a cash crisis created by minority stockholder Georgetown Basho Investors, LLC (GBI) by GBI intentionally withholding payments in violation of its obligations under a convertible promissory note and effectively preventing Basho's board from considering other funding options.

Ruling from the bench, Vice Chancellor Laster explained that the "complaint has a problem... the plaintiff, both as a director and as the managing member of the four stockholder entities, voted in favor of the transaction". Given that the plaintiff himself had approved the transaction, the court's analysis focused on the twin doctrines of waiver and acquiescence as possible defenses. Laster observed that while "ordinarily that's a great defense... this could be the case that is the exception that proves the rule". Because the complaint contained "specific detail about aggressive, self-interested, prolonged, abusive fiduciary misconduct... where the company is days from insolvency and has absolutely no alternatives to accepting the punitive financing", the court denied the defendants' motion to dismiss. In doing so, the court did not conclude that the transaction was subject to entire fairness review or even address the application of *Corwin*. However, the plaintiffs had alleged that the stockholder vote was infected by coercive conduct by GBI – specifically, that the independent stockholders had provided an irrevocable proxy to vote their shares "under extreme duress" due to Basho's liquidity crisis – which would ostensibly remove it from *Corwin's* reach, and which highlights a limitation of this doctrine.

### **Comment**

These three decisions offer important insights into the Delaware Court of Chancery's evolving view of the impact of stockholder approval on post-closing breach of fiduciary duty claims for money damages. At least one judge, Bouchard, held that such approval does not have a complete "cleansing" effect, and Laster's ruling in *Basho* confirms that *Corwin* will not enter the discussion where there are well-pleaded allegations of coercion. In addition, given the apparent tension between *C&J* and *Auspex*, it may be only a matter of time until the Delaware Supreme Court weighs in to clarify the applicable standard.

For further information on this topic please contact [C Thomas Brown](#) at Ropes & Gray LLP's New York office by telephone (+1 212 596 9000) or email ([thomas.brown@ropesgray.com](mailto:thomas.brown@ropesgray.com)). Alternatively, contact [Gregory Demers](#) at Ropes & Gray LLP's Boston office by telephone (+1 617 951 7000) or email ([gregory.demers@ropesgray.com](mailto:gregory.demers@ropesgray.com)). The Ropes & Gray website can be accessed at [www.ropesgray.com](http://www.ropesgray.com).

## Endnotes

- (1) *City of Miami General Employees' and Sanitation Employees' Retirement Trust v Comstock (C&J)*, CA 9980-CB (Del Ch Aug 24 2016), aff'd, 482, 2016 (Del Mar 23 2017).
- (2) 125 A 3d 304 (Del 2015).
- (3) *Id* at 305-06.
- (4) *Larkin v Shah*, CA 10918-VCS (Del Ch Aug 25 2016).
- (5) *Basho Technologies Holdco B, LLC v Georgetown Basho Investors, LLC*, CA 11802-VCL (Aug 26 2016).

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