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Reaffirmation That Stockholder Vote Will Cleanse Non-Conflicted Controller Transactions and Even Those Transactions Approved By Boards That Allegedly Were Not *Independent and Disinterested*—Merge Healthcare

Merge Healthcare Inc. Stockholders Litigation (Jan. 30, 2017) is the most recent decision reflecting an expansive interpretation by the Court of Chancery of the Delaware Supreme Court's seminal 2015 *Corwin* decision. The opinion confirms again the power of *Corwin* in "cleansing" a transaction based on stockholder approval in a fully informed vote. When *Corwin* applies, a transaction will be reviewed, post-closing, under the business judgment rule (regardless of the standard of review that was applicable pre-closing) and, as a result, challenges will be dismissed at an early stage of litigation.

Key Points

- ***Corwin* cleansing of non-conflicted controller transactions.** The court reaffirmed that fully informed stockholder approval cleanses a transaction *even if* the target company has a controller, so long as the controller's interests are aligned with the other stockholders' interests.
- ***Corwin* cleansing of transactions approved by allegedly non-independent directors.** The decision is the fourth post-*Corwin* Court of Chancery decision indicating that fully informed stockholder approval cleanses a transaction *even if* the directors who approved the transaction are alleged to have not been independent and disinterested.
- **Which transactions are excluded from *Corwin* cleansing.** Based on *Merge Healthcare* and other recent Court of Chancery opinions, it appears that the only transactions excluded from cleansing under *Corwin* are controller transactions in which the controller (a) "stands on both sides of the transaction" (such as a going-private transaction) or (b) extracts a personal benefit not shared by the other stockholders (such as receiving disparate merger consideration).

Background

The plaintiffs challenged the adequacy of the sale process, price and disclosure relating to the $1 billion acquisition of Merge Healthcare, Inc. (the "Company") by IBM. The plaintiffs alleged that the CEO-Chair-director-27% stockholder was a controller; and that the directors approving the transaction were not independent and disinterested, based on their alleged significant ties and relationships with him. The plaintiffs contended, further, that the directors had acted in their own personal interests in approving the transaction, motivated by obtaining liquidity, by obtaining post-merger employment with the surviving

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corporation and, in the case of the alleged controller, by collecting a $15 million consulting fee to which he would become entitled if the merger were consummated (although he waived his right to the consulting fee prior to the stockholder vote on the merger). The plaintiffs also claimed that the merger price (which represented a 32% premium above the unaffected stock price) was unfair and did not fully value the Company. Almost 80% of the shares outstanding voted in favor of the transaction—which, after excluding the 26% owned by the alleged controller, represented a majority of the disinterested shares. Vice Chancellor Glasscock rejected the plaintiffs' disclosure claims and dismissed the case at the pleading stage of litigation. The Vice Chancellor ruled that, under *Corwin*, approval by the disinterested stockholders in a fully-informed, uncoerced vote had cleansed the transaction.

Discussion

Transactions approved by a board that was allegedly not independent and disinterested will not be excluded from *Corwin* cleansing. In *Corwin*, the Delaware Supreme Court held that "when a transaction that *is not subject to the entire fairness standard* is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies" (*emphasis added*). Generally, a transaction may be subject to the entire fairness standard if (i) it is a controller transaction where the controller's interests are not aligned with the interests of the other stockholders or (ii) it was approved by a board that was not independent and disinterested. The *Corwin* opinion did not clarify whether *all* transactions that would otherwise be subject to entire fairness (*i.e.*, transactions described in (i) *or* (ii) above) would be excluded from "cleansing" under *Corwin*, or whether it was only transactions described in (i) above (as was the situation in *Corwin*) that would be excluded. Chancellor Bouchard suggested in the Court of Chancery's opinion in *Corwin* that *only those transactions described in (i) above would be excluded from Corwin cleansing*. Since *Corwin*, the Court of Chancery has issued two additional opinions endorsing that suggested approach (*Solera*, Jan. 5, 2017, written by Chancellor Bouchard, and *Larkin v. Shah*, Aug. 25, 2016, written by Vice Chancellor Slights). *Merge Healthcare* is now the third post-*Corwin* opinion suggesting that transactions approved by a board that allegedly was not independent and disinterested will not be excluded from cleansing under *Corwin*. As noted, the Delaware Supreme Court has not addressed this issue.

Controller transactions will be excluded from *Corwin* cleansing only if the controller's interests are not aligned with the interests of the other stockholders. *Merge Healthcare* reaffirms that *Corwin* will not apply (and the entire fairness standard of review will apply), post-closing, only when a controller "stands on both sides of the transaction" (*i.e.*, is himself the buyer, as in a going-private transaction) or extracts a personal benefit not shared by the other stockholders (such as receiving different compensation or receiving a consulting fee contingent on consummation of the transaction). In such a situation, the court explained (consistent with longstanding Delaware jurisprudence) that coercion is deemed "inherently present" and the transaction cannot be cleansed. In *Merge Healthcare*, the court found that the alleged controller's interests *were* aligned with the other stockholders' interests. Although the alleged controller had a consulting arrangement with the Company pursuant to which he was entitled to a $15 million consulting fee if the Company entered into the merger with IBM, during negotiation of the deal with IBM, he waived the fee in exchange for IBM's increasing the aggregate merger consideration by $15 million. The plaintiffs argued that the waiver "came too late and … the sale process [had] already [been] 'poisoned' by the existence of th[e] fee." The court disagreed, stating that the waiver fully aligned the controller's interests with those of the other stockholders. The court noted, further, that the controller, as the largest stockholder of the Company, had every incentive to negotiate for the highest possible price, and that he would receive $188 million on the sale, which "dwarf[ed] the consulting fee."

Amplification of the meaning of the "waste" standard under *Corwin*. The Delaware courts have previously clarified that, when the business judgment rule applies under *Corwin*, a post-closing challenge to the transaction will be dismissed at an early stage of the litigation unless the transaction constituted "waste." The courts have characterized "waste" as a "vestigial" and "only theoretical" standard, with "little real-world relevance"—particularly in the *Corwin* context, because, as Vice Chancellor Glasscock noted in *Merge Healthcare*, "it is difficult to envision a majority vote in favor of a transaction so unfavorable as to constitute waste." On this basis, it has been difficult to fathom what purpose the waste standard serves. In a footnote in the *Merge Healthcare* opinion, the Vice Chancellor provided the following helpful further explication: "[W]aste is best viewed [in the *Corwin* context] as a kind of 'judicial out,' a way around the strictures of the cleansing rule given a fact situation of some undefined level of egregiousness, such that equity would intervene."

Reaffirmation of the court's stringent "materiality" standard for disclosure claims. The court found that the plaintiffs had not alleged disclosure violations involving material information. Consistent with other recent Delaware decisions dismissing post-closing disclosure claims made in the context of plaintiff arguments that *Corwin* cleansing should be held inapplicable because the stockholder vote was not "fully informed," the court reiterated:

> 'Fully informed' does not mean infinitely informed…[and] information [need not] be disclosed simply because…it would be helpful, or interesting…. [Rather, information will be found material if,] from the perspective of a reasonable stockholder, there is a substantial likelihood that it significantly alters the total mix of information made available. Redundant facts, insignificant details, or reasonable assumptions need not be disclosed…[and the summary of the financial advisor's analysis does not require] a cornucopia of financial data, but rather an accurate description of the advisor's methodology and key assumptions…[that is] sufficient for the stockholders to usefully comprehend, not recreate, the analysis.

Practice Points

As discussed, the opinion reaffirms that, in the *Corwin* context, the court will apply a high bar to finding that an alleged non-disclosure may be "material." **The court concluded as follows with respect to the *Merge Healthcare* plaintiffs' specific disclosure claims:**

- ***Alleged controller's waiver of the consulting fee.*** The plaintiffs argued that the proxy misleadingly suggested that the controller waived his consulting fee for the purpose of obtaining a price increase, when there was evidence that his purpose was avoiding formation of a special committee that would exclude him. The court stated that disclosures relating to a board's "subjective motivation or opinions" (*i.e.*, "asking why") does not state a meritorious disclosure claim.

- ***Atypical treatment of SBC.*** "[Even] [a]ssuming for purposes of this argument that the accounting treatment of SBC [(stock-based compensation)] would be material to stockholders," it was not necessary to disclose that, in the financial advisor's DCF analysis, the advisor "atypically" treated SBC as a cash expense. The court reasoned that the proxy disclosed the Company's unlevered-free-cash-flow (UFCF) projections; disclosed that the advisor used the UFCF projections; and disclosed that, in creating the UFCF projections, management used GAAP earnings (which, as the defendants had pointed out, requires treatment of SBC as a cash expense).

- ***SBC projections.*** Disclosure of the Company's projections for SBC for 2015-2019 were not required, as the proxy provided a "detailed summary of [the advisor]'s work, including projections for Revenue, Gross Profit, EBITDA, EBIT, Net Income, Earnings Per Share, and UFCF. Therefore,… it [was] not reasonably conceivable that the actual projections of SBC, while they might [have been] of interest to stockholders, [were] necessary for a fair summary of [the advisor]'s work in light of the disclosures actually made."

- ***NOLs' present value.*** A separate value for the Company's net operating losses (NOLs) was not required. The court rejected the plaintiffs' contention that the NOLs had to be disclosed as a "key input" pursuant to *Netsmart* (where the court held that "the valuation used to arrive at [a banker's] opinion as well as the *key inputs* and range of ultimate values generated by those analyses must … be fairly disclosed"). The Vice Chancellor wrote: "I fail to see how the separate disclosure of the present value of NOLs under the facts here would alter the total mix of information available to the stockholders given the detailed fair summary of [the financial advisor]'s work already contained in the Proxy."

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