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Solera *Decision Underscores (Again) Difficulties of Challenging a Transaction That Was Approved by Disinterested Stockholders*

In *Solera Stockholders Litigation* (Jan. 5, 2017), a former stockholder of Solera Holdings, Inc. sought post-closing damages in connection with the acquisition of Solera by Vista Equity Partners, a private equity firm, in a $3.7 billion merger. The plaintiff in effect alleged that the Solera directors, in violation of their *Revlon* duties, had concentrated on private equity buyers rather than strategic buyers, had favored Vista over the other bidders, and had created a conflict of interest (which was not disclosed to stockholders) by shifting the company's bonus programs that incentivized long-term growth of the company to a short-term retention program that incentivized management to sell the company.

The decision follows an increasingly familiar template. Based on the landmark 2015 *Corwin* decision, Chancellor Bouchard:

- Rejected applying enhanced scrutiny under *Revlon* in a post-closing action;
- Held that the merger was "subject to the business judgment presumption because, in a fully-informed and uncoerced vote, a disinterested majority of Solera's stockholders approved" it;
- Found the nondisclosure claims to be without merit; and
- Dismissed the plaintiff's claims at the pleading stage of the litigation.

It should be noted that the case involved a fact pattern that was positive for the defendants, as the sale process included solicitation of both financial and strategic buyers; although only financial buyers ultimately submitted offers, the merger agreement permitted continuing discussions with the one potentially interested strategic buyer; the board selected the highest offer made; the merger price represented a 53% premium over the unaffected stock price; and seven of eight members of the board, and all members of the Special Committee, were independent and disinterested.

Key Points

- **The court reiterated, that, based on *Corwin*, post-closing damages actions challenging transactions that have been approved by the disinterested stockholders in a "fully-informed" vote will be accorded great deference and should be dismissed at the pleading stage.** The decision thus underscores the critical issue in these cases of whether the disclosure to stockholders was sufficient for the stockholder vote to be deemed "fully-informed."

- **The court clarified that the plaintiffs have the "burden of *pleading*" that the vote was not "fully-informed."** In other words, there is no burden on the defendants to prove that a vote was "fully-informed" unless the plaintiffs identified and made a colorable claim that material information was not disclosed. Thus, as the court acknowledged, plaintiffs have the burden of pleading disclosure deficiencies before they have the opportunity to conduct discovery.

- **The decision underscores that there is a high standard for establishing the materiality of claims challenging proxy statement disclosure.** The court reiterated that information is not "material" simply because it might be *helpful* to stockholders in deciding how to vote, but only if there is a substantial likelihood that a reasonable stockholder would consider it *important* in deciding how to vote (*i.e.*, that it would change the "total mix of information" made available to stockholders). The court rejected the plaintiff's contention that *Corwin*, by stating that "all troubling facts about directors' behavior" should be disclosed, changed the materiality standard to include *all* "troubling facts" about directors' behavior. The Chancellor—consistent with well-established principles regarding disclosure—held that information (whether "troubling facts" about director conduct or otherwise) must be disclosed only where it is material.

- **The court underscored that, in evaluating disclosure claims, it is the quality of the disclosure—not the underlying merits of the acts allegedly not adequately disclosed—that is relevant.** For example, in this case, the court emphasized that the plaintiffs' disclosure claims—which related to the incentive compensation arrangements that the company put into place for management during the sale process—were, in the court's view, not focused on the *quality of the disclosure* to stockholders regarding the arrangements but on the *substantive merits* of the compensation arrangements. The distinction drawn by the court is important, as post-*Corwin*, there has been an increasing trend of plaintiffs attempting to re-characterize substantive challenges into disclosure claims to avoid the application of *Corwin*.

- **The court appeared to endorse the view that the *only* transactions not subject to potential "cleansing" under *Corwin* are controller transactions.** The Chancellor noted, and appeared to agree with, Vice Chancellor Slights' interpretation of *Corwin* (expressed recently in *Larkin v. Shah*). Vice Chancellor Slights concluded that *Corwin*'s exclusion of transactions "otherwise subject to entire fairness review" means only those transactions that are subject to entire fairness due to a controller being involved—and that a transaction that would be subject to entire fairness review because a majority of the directors approving the transaction were not independent and disinterested *would* be cleansed by a fully-informed, uncoerced vote of disinterested stockholders.

Background

The sale process. Over a two-year period, the founder-CEO-Chair of Solera (Aquila) engaged in informal discussions with private equity firms regarding a potential going-private transaction. One of the firms ("Party A") submitted a written indication of interest, including confirmation that Aquila and his team would be provided with post-merger management positions. Solera's eight-member board (comprised of Aquila and seven outside directors) then formed a Special Committee, comprised of three of the outside directors, to consider strategic alternatives. The Committee engaged independent financial and legal counsel. The Committee contacted six private equity firms and five strategic companies, but excluded one strategic company that was a competitor (Party B). Written indications of interest were received from Vista, Party A and two other private equity firms. The Committee introduced Vista and Party A to potential financing partners. Ultimately, Vista, Party A and another private equity firm submitted offers. Vista's bid (which was financed by the partner introduced by Solera) was the highest bid. After a news leak that the sale process was underway, Party B indicated that it would be interested in submitting an offer. A sudden significant drop in global equity markets then ensued, as a result of which the bidders revised their offers downward. At one point, the Committee contacted Vista, telling Vista that it would have to raise its bid to at least a specified amount (the amount of the highest bid Solera then had). Thereafter, the bidders again revised their offers a number of times, and Vista's bid ultimately was again the highest. The board unanimously approved Vista's offer, which represented a 53% premium to the unaffected stock price.

The merger agreement. The merger agreement permitted Solera to continue discussions with Party B for 28 days after signing; provided Vista with the right to match all alternative offers; and provided for a termination fee of (a) $38.15 million (about 1% of the equity value of the merger) and $5 million in expense reimbursement, to be paid by Party B if Solera entered into an agreement with it during the 28-day period and (b) $114.4 million (3% of the equity value of the merger), payable by any other successful alternative bidder (or by Party B if Solera terminated the merger agreement after the 28-day period). Party B ultimately withdrew from the process during the 28-day period, citing a decline in its stock price and volatility in the financing markets.

Payments to management during the process. During the sale process, the Special Committee discussed implementing a new management retention and compensation plan. The Special Committee referred the issue to the board's Compensation Committee (which was comprised of three directors, two of whom were also on the Special Committee). The Compensation Committee approved a Retention Plan that would pay $33 million to Solera's management. Of that amount, $18 million would be payable to Aquila (half only on closing of a transaction and half payable after one year even if the sale of the company fell through). The Retention Plan also included large payments to the CFO and the General Counsel, payable only on closing of a transaction. In addition, the Compensation Committee paid a "special cash award" to Aquila of $10 million, purportedly for performance unrelated to sale of the company.

Discussion

The court reaffirmed that, under *Corwin*, it will dismiss at the pleading stage post-closing claims challenging a transaction that was approved by the disinterested stockholders in a fully-informed, uncoerced vote. The plaintiff's complaint alleged that, in the sale process, the directors, in violation of their *Revlon* duties, had improperly favored the interests of Aquila and Solera's management, failed to establish an effective Special Committee or extract the highest possible price for the company, implemented preclusive deal protection devices, and failed to disclose material information about the value of Solera's stock. The court rejected the application of *Revlon*. Citing *Corwin*, the court reiterated that *Revlon* is "a tool" for pre-closing injunctive relief, not for post-closing money damages. Under *Corwin*, in the post-closing context, "when a transaction not subject to the entire fairness standard is approved by a fully-informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies," the court wrote. The court also reaffirmed that, based on the "waste" standard applicable under business judgment review, dismissal is typically the result because "it has been understood that stockholders would be unlikely to approve a transaction that is wasteful." The court reiterated that application of the business judgment standard is intended to avoid "the uncertainties and costs of judicial second-guessing when the disinterested stockholders have had the free and informed chance to decide on the economic merits of the transaction for themselves."

The court rejected the plaintiff's claims that the stockholder vote was not "fully-informed." The decision is in line with recent cases that suggest that plaintiffs bear a relatively high burden to succeed on claims that a stockholder vote was not fully-informed (although we note that, in this case, the disclosure claims appeared to be particularly weak).

- **The court validated existing practice with respect to plaintiffs' "*pleading* burden" as to the sufficiency of the stockholder vote.** The court reviewed that a defendant that seeks to obtain the cleansing effect of a stockholder vote bears the burden of proof with respect to whether the vote was "fully-informed." The court stated, however, that, there is no burden on the defendants to prove that the vote was fully-informed *unless* the plaintiff pled that the vote was *not* fully informed—in other words, the plaintiff bears the burden of pleading (*i.e.,* identifying and making a colorable claim relating to) a disclosure deficiency in the proxy statement. The court stated that it "makes little sense" for the defendant to bear the *pleading* burden, as it would put him in the "unworkable" position of having to prove a negative and having to identify and respond to disclosure deficiencies not complained of by the plaintiff. The court noted that this approach has been the practice since *Corwin* was decided. The court acknowledged issues of potential unfairness for plaintiffs in having to plead disclosure deficiencies before they have had the opportunity to conduct discovery, but noted "the reality" that "plaintiffs must plead claims before receiving discovery in American civil litigation all the time." (The court noted that the ability to conduct a books and records inspection "functionally serves as an important exception in the context of non-expedited stockholder litigation"—although the plaintiff in this case did not avail itself of that opportunity.) The court noted, further, that plaintiffs have the advantage, in the context of deal litigation, of the "relatively low pleading standard of 'colorability' to obtain discovery in aid of disclosure claims before a stockholder vote," which is "the preferred time to address such claims."

- **The court rejected the plaintiff's contention that "all troubling facts regarding director behavior" must be disclosed.** The court emphasized that, when evaluating disclosure claims, "the essential inquiry is whether the alleged omission or misstatement is material." The court reviewed the longstanding doctrine that information is not "material" simply because it "might be helpful," but only if there is a "substantial likelihood that a reasonable stockholder would consider it important in deciding how to vote"—that is, only if "there is a substantial likelihood that it significantly alters the 'total mix' of information made available." The court addressed the plaintiff's contention that *Corwin* had modified this doctrine by stating that the defendants there had been obligated to disclose "all troubling facts regarding director behavior." Chancellor Bouchard rejected that interpretation, concluding that, taken in context, the *Corwin* reference to "all troubling facts" meant all troubling facts *that are material*.

- **The court rejected the plaintiff's disclosure claims on the basis that, in each case, the disclosure was adequate and, in any event, the information was not material.**

  - **Alleged conflict of Compensation Committee.** Two of the three members of the Compensation Committee were also Special Committee members. The plaintiff contended that the company had "created a false impression" that the Special Committee members were not also making compensation decisions, by (i) not naming the

Compensation Committee members in the proxy and (ii) stating in the proxy that, due to the corporate governance issues raised by consideration of the Retention Plan during the sale process, the Special Committee had decided that consideration of the Plan should be done by the Compensation Committee. The court rejected the claim, based on the facts that the proxy statement named the members of the Special Committee; the proxy specifically incorporated by reference the company's 10-K/A that was filed two days earlier; and the 10-K/A named the members of the Compensation Committee. "[D]ocuments incorporated by reference into a disclosure statement may be considered to be disclosed," the court wrote. In addition, the court concluded, even if the inference suggested by the plaintiff had been drawn by stockholders, it would have been immaterial, primarily because, given that the merger was approved unanimously by all eight directors, seven of whom were independent and disinterested, it was not important that two members of the Special Committee also served on the Compensation Committee.

- **Alleged "purpose and effect" of payments to management during the sale process.** The plaintiff contended that the board's approval of incentive payments conditioned on closing of a sale incentivized management to support selling the company. The plaintiff argued that the Retention Plan served no legitimate purpose because there already were retention plans in place for Solera's management (including those receiving awards under the Retention Plan). The court noted that these arguments related to the underlying merit of the board's compensation decisions, and not the quality of the disclosure to stockholders regarding those decisions. As to the plaintiff's complaint that the proxy did not disclose the reasons that Solera was, in the plaintiff's view, "shifting its compensation strategy," the court stated that the compensation plans were fully disclosed and that "asking why does not state a meritorious disclosure claim under Delaware law."

- **Alleged misleading nature of the disclosure regarding the special cash payment to the CEO.** The proxy stated that the $10 million "special cash payment" to Aquila was made in recognition of Aquila's good performance and was unrelated to the company's exploration of strategic alternatives or the merger. The plaintiff claimed that the disclosure was misleading in that it suggested that Aquila had not already been compensated for his performance under the company's other existing incentive plans. Specifically, the plaintiff noted that certain performance criteria used to determine Aquila's compensation under the existing plans were similar to the criteria on which the special cash award was based. The court commented that the contention "once again appear[s] to reflect more a disagreement with the merits of the compensation decision than a disclosure claim." The court noted that the proxy disclosed "the amount, nature and timing" of the award. Moreover, the court wrote, the details of the award were "immaterial" to the stockholders in deciding whether to approve the proposed merger. The award "logically had no impact on who the company was sold to because it had been paid and the money was out the door before the final bids were submitted and the Merger Agreement was signed," the court explained.

The court appeared to endorse the view that a fully informed stockholder vote would "cleanse" even a transaction approved by a board that was not independent and disinterested. *Corwin* held that a fully informed, uncoerced stockholder vote would "cleanse" any transaction *other than* one that otherwise would be subject to the entire fairness standard of review. We note that a transaction may be subject to entire fairness if either (i) as was the case in *Corwin*, a controller is involved (because a controller "stands on both sides of the transaction") *or* (ii) a majority of the board of the target company is not independent and disinterested (because the business judgment presumptions are premised on judicial deference to the decisions of an independent and disinterested board). What is uncertain is whether *Corwin* should be interpreted as prohibiting business judgment deference (a) in the case of *all* transactions that otherwise would be subject to entire fairness or (b) only in the case of transactions that would be subject to entire fairness because a controller is involved (*i.e.*, only under prong (i) above). In a footnote in *Solera,* the Chancellor notes, and appears to endorse, Vice Chancellor Slight's view, stated last year in *Larkin v. Shah,* that only controller transactions cannot be cleansed under *Corwin.* Thus, at least in the views of the Chancellor and Vice Chancellor Slight, and absent further clarification by the Delaware Supreme Court, it appears that business judgment review would be applied to a transaction approved by a fully informed, uncoerced vote of the disinterested stockholders even if a majority of the directors that approved the transaction allegedly had been non-independent or motivated by a significant personal interest in the transaction.

Practice Points

- **Importance of disclosure.** Like numerous other recent decisions, *Solera* underscores the critical importance of adequate disclosure in M&A deals following *Corwin*. The decision furthers the Delaware courts' trends over the past couple of years that lean strongly toward favoring (i) application of business judgment review and early dismissal of post-closing complaints challenging M&A transactions and (ii) finding disclosure claims in post-closing actions to be without merit, based on the disclosure having been adequate and/or the information not having been material.

- **The "essential inquiry" with respect to a disclosure claim is generally whether the information at issue was "material."** Information that would have been merely "helpful" to stockholders in determining how to vote will not be deemed "material'; rather, information that a "reasonable stockholder" would have found "important" in determining how to vote (*i.e.*, that would have had a substantial likelihood of changing the "total mix" of information available to stockholders) would be "material."

- **Plaintiffs cannot repackage substantive challenges to director conduct as disclosure claims to avoid the application of *Corwin*.** In evaluating a disclosure claim, the court will focus on the quality of the disclosure, rather than the plaintiff's disagreement with the underlying merits of the subject matter of the claim. In the context of a disclosure claim relating to the inadequate disclosure of a compensation arrangement, for example, the claim should be focused on whether the terms of the arrangement are adequately disclosed, not on the wisdom of the board's approving the arrangement.

- **Plaintiffs bear the "pleading burden" with respect to the fully informed nature of a stockholder vote.** Unless a plaintiff makes a colorable pleading that identifies a disclosure deficiency in the proxy statement, the defendants will not need not prove that a vote was fully-informed for the transaction to be cleansed under *Corwin*.

- **Information incorporated into the proxy by reference should be considered disclosed.** This would be particularly true when the information is specifically referenced in the proxy section to which the incorporated information is relevant and where the document incorporated by reference has been recently filed.

- **Continuing a sale process after a market disruption.** Although not addressed in the *Solera* opinion, we note that the board continued the sale process after a significant drop in the global equity markets and that, as would be expected, the bidders then revised their offer prices downward. In the event of materially changed circumstances during a sale process, including market disruption, the board should be aware of and consider the possible impact of those circumstances in reaching a decision as to whether and how to continue the process.

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Authors:

Andrew J. Colosimo

Aviva F. Diamant

Christopher Ewan

Arthur Fleischer, Jr.

Andrea Gede-Lange

David J. Greenwald

Randi Lally

Mark H. Lucas

Scott B. Luftglass

Brian T. Mangino

Robert C. Schwenkel

David L. Shaw

Peter L. Simmons

Matthew V. Soran

Steven J. Steinman

Gail Weinstein

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Contacts:

New York

Jeffrey Bagner	+1.212.859.8136	jeffrey.bagner@friedfrank.com
Abigail Pickering Bomba	+1.212.859.8622	abigail.bomba@friedfrank.com
Andrew J. Colosimo	+1.212.859.8868	andrew.colosimo@friedfrank.com
Warren S. de Wied	+1.212.859.8296	warren.dewied@friedfrank.com
Aviva F. Diamant	+1.212.859.8185	aviva.diamant@friedfrank.com
Steven Epstein	+1.212.859.8964	steven.epstein@friedfrank.com
Christopher Ewan	+1.212.859.8875	christopher.ewan@friedfrank.com
Arthur Fleischer, Jr.*	+1.212.859.8120	arthur.fleischer@friedfrank.com
Andrea Gede-Lange	+1.212.859.8862	andrea.gede-lange@friedfrank.com
David J. Greenwald	+1.212.859.8209	david.greenwald@friedfrank.com
Randi Lally	+1.212.859.8570	randi.lally@friedfrank.com
Mark H. Lucas	+1.212.859.8268	mark.lucas@friedfrank.com
Scott B. Luftglass	+1.212.859.8968	scott.luftglass@friedfrank.com
Philip Richter	+1.212.859.8763	philip.richter@friedfrank.com
Steven G. Scheinfeld	+1.212.859.8475	steven.scheinfeld@friedfrank.com
Robert C. Schwenkel	+1.212.859.8167	robert.schwenkel@friedfrank.com
David L. Shaw	+1.212.859.8803	david.shaw@friedfrank.com
Peter L. Simmons	+1.212.859.8455	peter.simmons@friedfrank.com
Matthew V. Soran	+1.212.859.8462	matthew.soran@friedfrank.com
Steven J. Steinman	+1.212.859.8092	steven.steinman@friedfrank.com
Gail Weinstein*	+1.212.859.8031	gail.weinstein@friedfrank.com

Washington, D.C.

Jerald S. Howe, Jr.	+1.202.639.7080	jerry.howe@friedfrank.com
Brian T. Mangino	+1.202.639.7258	brian.mangino@friedfrank.com
Brian Miner	+1.202.639.7340	brian.miner@friedfrank.com

*Senior Counsel