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Unusual Facts Preclude "Cleansing" of Stockholder-Approved Merger, But the Power of Corwin *Continues* —Saba Software

Saba Software, Inc. Stockholder Litigation (March 31, 2017) is the first case that we are aware of in which the Delaware Court of Chancery has declined to apply "cleansing" under *Corwin*. The decision appears to be grounded in the unusual facts of the case, and, in our view, confirms the recent trend of Delaware decisions that indicate that *Corwin* cleansing of non-controller stockholder-approved transactions is likely to be precluded only in unusual and egregious circumstances.

Background. In March 2015, Saba Software, Inc. was acquired by private equity firm Vector Capital Management, in a $9 per share all-cash merger (the "Merger"). The SEC had previously determined that, from 2008 to 2011, Saba engaged in fraud by which it had overstated its pre-tax earnings by $70 million. Saba thereafter repeatedly represented, for over three years, that it would restate its financial statements to account for the fraud—but it never did. In September 2014, Saba reached a settlement with the SEC, which included a February 2015 final deadline for the restatement (the "Restatement"). Saba's stock price was $14 per share after announcement of the settlement. Saba continued a long-standing exploration of strategic alternatives and, in November 2014, received an indication of interest from one potential buyer, at $11 per share. In December, Saba announced that it was going to miss the SEC Restatement deadline (which resulted in its stock dropping to $8.75); and it intensified its exploration of a possible sale.

In January 2015, Saba received the $9 offer from Vector (which represented a 2% discount to the then trading price). Saba agreed to a six-day exclusivity agreement with Vector; and, just before it expired, Saba obtained a fairness opinion and entered into the Merger Agreement with affiliates of Vector. When the SEC Restatement deadline was missed five days later, the SEC deregistered Saba's stock (rendering the shares illiquid). Saba stockholders approved the Merger just 44 days later (as SEC review of the proxy materials was no longer required due to the deregistration); and the Merger closed. Vice Chancellor Slights rejected the defendants' motion to dismiss the plaintiff's claims against the Saba directors.

Key Points

- **First decision to find that the *Corwin* prerequisites to "cleansing" were not met—but the findings were based on the *unusual factual context*.** The court found it "reasonably conceivable" that the Saba stockholders' approval of the Merger was "neither fully informed nor uncoerced," and, therefore, that *Corwin* would *not* apply. Importantly, the court's judgments were based squarely on the unusual and egregious facts of the case, and we do not believe that it represents any retrenchment of the court's general approach in broadly interpreting and applying *Corwin*.

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- **The court found that the stockholder vote may not have been "fully informed"—based on the omission of any explanation as to *why* the Restatement was never completed.** The court found that a reasonable stockholder could not have "meaningfully assessed" the standalone value of the Company without knowing (i) why the Company had never completed the Restatement, and (ii) what post-deregistration alternatives were available to the Company if it remained a standalone company.

- **The court found that the stockholder vote may have been "coerced"—based on "situational coercion" resulting from the failure to complete the Restatement.** The court reasoned that stockholders had only a "Hobson's choice" to "choose between keeping their recently-deregistered, illiquid stock or accepting [the depressed] Merger price." This "situational coercion," created by the board, with the stockholders having "no practical alternative but to accept the Merger," was sufficient for a claim of coercion to survive a motion to dismiss, even without "affirmative action" by the board to coerce the stockholders, the court ruled.

- **The court found that the directors may have acted in "bad faith" and breached the duty of loyalty (notwithstanding an apparently adequate sales process)—based on their failure, without explanation, to complete the Restatement.** While the sale process appeared to be adequate, "there was an elephant in the boardroom"—that is, that the Company had engaged in fraud and then had "repeatedly" and "inexplicably" failed to complete the Restatement. In addition, the court found, the directors may have been motivated to sell the Company to monetize significant equity awards that would have been worthless had the Company remained a standalone entity (and the stock deregistered).

- **While the court found the plaintiff's claims described above to be valid based on the unusual facts of the case, the court, consistent with recent precedent, dismissed claims that:** (i) the board acted in "bad faith" by engaging a financial advisor that it knew had done work for the buyer; (ii) the proxy statement should have disclosed more information about (a) the financial advisor's services provided in the past to the buyer and (b) the advisor's financial analyses underlying the fairness opinion; (iii) the CEO, who led the Merger negotiations, was motivated by continuing his employment after the Merger; and (iv) the buyer "aided and abetted" the target directors' breaches.

Discussion

First decision to find that the *Corwin* prerequisites to "cleansing" were not met—but the findings were based on the *unusual factual context*. Under *Corwin*, stockholder approval will "cleanse" a transaction (*i.e.*, will permit application of the highly deferential business judgment standard of review to a post-closing challenge of the transaction), so long as the stockholder vote was "fully informed" and "uncoerced." Since *Corwin* was decided in 2015, the Delaware courts have found, in every case seeking *Corwin* cleansing, that the stockholder vote *was* fully informed and non-coerced. *Saba*, as far as we are aware, is the first case in which the court has found that a stockholder vote was *not* "fully informed" and "uncoerced." As a result of that finding, the court held that *Corwin* was inapplicable and that the heightened scrutiny of the *Revlon* standard of review would apply. Importantly, as noted, *the court's judgments in Saba were based on the unusual and egregious facts of the case,* and we do not believe that the opinion suggests that *Saba* represents any retrenchment of the court's general approach in interpreting and applying *Corwin* broadly.

Critical role of the unusual factual context of the case. The key unusual facts in *Saba* were that the Company had engaged in fraud and then had repeatedly, *and without explanation*, failed to complete the Restatement—which led to a "tragic requiem" of events, including deregistration of the Saba common stock. The plaintiff alleged that the Saba directors had "rushed the sale process" and agreed to an unfair price because they wanted to avoid further regulatory scrutiny relating to the fraud and wanted to be in a position to cash in significant equity awards that would be triggered by a sale but otherwise would be worthless due to the deregistration of the shares. We note that the directors' *financial* interests (given their equity awards) were aligned with the stockholders' interests in the Restatement being completed (so that deregistration could be avoided or, later, re-registration would be possible). The board's failure, then, to complete the Restatement for over three years, with the reason "remain[ing] a mystery," arguably could not have been explained on any ground other than bad faith (relating, presumably, to the "fraudulent scheme" in which the Company had previously engaged). Thus, we note, arguably, the alleged facts here may have been sufficiently egregious as to have satisfied even the almost-impossible-to-satisfy standard of "waste"—meaning that the case might not have been dismissed even if the court *had* applied business judgment review under *Corwin*.

The court found that the vote may not have been "fully informed"—based on the omission of any explanation as to why the Restatement was never completed. The proxy described the consequences of the deregistration; provided the date when the company expected the Restatement would be completed if Saba were not sold; and projected the value of Saba as a standalone company if the Restatement was completed at the projected date (or, if not, was completed at year-end, which was four months later). However, the court stated, "[g]iven [the Company's] past history [of repeated failures to complete the Restatement], ...unless the stockholders were armed with information that would allow them to assess the likelihood that Saba would ever be able to complete [the Restatement], they would have no means to evaluate the choice they were being asked to make—[to] accept merger consideration that reflected the depressed value caused by the Company's regulatory non-compliance or [to] stay the course in hopes that the Company might return to the good graces of the SEC" and have its shares re-registered. In addition, the court noted that stockholders might "need all material information regarding the likelihood that Saba could ever complete the Restatement" in order to "meaningfully assess" the credibility of the management projections, which assumed that the Restatement would be completed at some point. "Without the means to test that assumption by drilling down on the circumstances surrounding [Saba]'s past and latest failure to deliver its restated financials," given that Saba had repeatedly failed to meet deadlines for the Restatement, the "stockholders had no basis to conclude whether or not the projections made sense."

The court acknowledged that it has repeatedly held that "asking 'Why?' does not state a meritorious disclosure claim." In other words, while a board's decisions must be disclosed, generally the board need not explain why it made a decision. In past cases, however, the court explained, the rejected "Tell me why" claims related to a "purposeful decision" of the board, officers or an advisor, while, in this case, the question related to an important "factual development" (the non-completion of the Restatement).

The court found that the stockholder vote also may not have been "fully informed" based on non-disclosure of the post-deregistration alternatives available to the Company as a standalone company. The court acknowledged that Delaware law does not typically require disclosure of "the panoply of possible alternatives" to the course of action being proposed by a board—because stockholders have a "veto power over fundamental corporate changes" such as a merger, but entrust

management with evaluating alternatives and deciding which fundamental changes to propose." However, the court wrote:

> While this holds true in a typical case, this is hardly a typical case given the deregistration of Saba's shares...just prior to the time the stockholder vote on the Merger was to occur. This caused a fundamental change to the nature and value of the stockholders' equity stake in Saba over which the stockholders had no control. The deregistration also dramatically affected the environment in which the Board conducted the sale process and in which the stockholders were asked to exercise their franchise. The Board needed to take extra care to account for this dynamic in its disclosures to stockholders.

In considering whether or not Saba was viable as a standalone going concern, a reasonable stockholder would have needed to understand what financing alternatives would have been available to Saba if it were not sold, the court stated. Further, a reasonable stockholder may have found it important to know that Saba's financial advisor, when advising the special committee about an indication of interest by a different party, stated that that transaction— which, like the Merger, was at "a discount to current market prices"—would "eliminate further upside for investors from standalone value creation" and "could trigger likely shareholder litigation due to price below market."

The court found that the stockholder vote may have been "coerced"—based on "situational coercion" resulting from the failure to complete the Restatement. Due to "situationally coercive factors" that were "created by the Saba Board," the stockholders had "no practical alternative but to vote in favor of the Merger," according to the court. "Situational coercion," according to the court, resulted from the Company having engaged in fraud and then not completing the Restatement. Further, "the forced timing of the Merger and the proxy statement's failure to disclose why the Restatement had not been completed and what financing alternatives might [have been] available to Saba if it [had] remained a standalone company, left the stockholders staring into a black box as they attempted to ascertain Saba's future prospects as a standalone company," the court stated. The board, essentially, "forced stockholders to choose between a no-premium sale or holding potentially worthless stock." The defendants had argued that, to find coercion, there had to have been "some affirmative action by the fiduciary in connection with the vote that reflect[ed] some structural or other mechanism for or promise of retribution that would place the stockholders who reject the proposal in a worse position than they occupied before the vote." The court disagreed that the defendants had not taken affirmative action, but also disagreed that affirmative action was a predicate to wrongful coercion. "Inequitable coercion can exist as well when the fiduciary fails to act when he knows he has a duty to act and thereby coerces stockholder action," the court wrote.

The court found that the directors may have acted in "bad faith" (notwithstanding an apparently adequate sales process)—based on the failure to complete the Restatement. The court acknowledged that, in light of the Saba charter's exculpation of directors for duty of care violations, to state an actionable *Revlon* claim, the plaintiff had to plead that directors had "consciously disregarded their duties, knowingly and completely failed to undertake their responsibilities, and utterly failed to attempt to obtain the best sale price." The court stated that "bad faith" was not "at first glance" apparent from the sale process "narrative." The process included an independent special committee; an additional independent "oversight" committee; management-prepared and board-considered projections; outreach to numerous potentially interested parties; indications of interest from a number of parties; attempts (albeit unsuccessful) to negotiate a higher price; selection of the highest proposal; and reliance on an independent financial advisor's fairness opinion. However, the court stated: "There was an elephant in the boardroom from 2012 forward**."** The "elephant" was that the Company had engaged in fraud and, without

explanation, had repeatedly failed to restate its financials to account for the fraud. The plaintiff claimed that these facts, and the ensuing events, including deregistration, led the board to "rush" the sale process and to refuse to consider alternatives to a sale—so that further regulatory scrutiny would be avoided and so that the directors and management would be in a position to cash in significant equity awards that would be worthless without the Merger. The court characterized its ruling that the bad faith claim was sufficient to survive the motion to dismiss as a "close call."

The court found that the directors may have breached the duty of loyalty—based on their monetizing equity awards that would have been worthless without a sale. Saba had been unable to make equity awards to its directors for an extended time due to its need to restate its financials. Then, in January 2015, in the midst of the sale process, the board approved an equity award to all independent directors. The day before the Merger Agreement was signed, the board approved conversion of the equity awards into the right to receive cash payments on a change of control. The court acknowledged that it is "not at all uncommon for companies to address outstanding executive compensation on the eve of a merger." The court wrote: "In the ordinary course,...this timing would hardly support an inference of self-interest. However, again, this is not the typical case." Here, according to the court, the "looming deregistration neutralized the equity awards; [and] the prospect of a merger with [Vector] was the only means to revive them and convert them to cash." It was reasonably conceivable that this fact "would steer the Defendant Directors away from the standalone option, even if that option was in the best interests of the stockholders," the court concluded. "The fact that the Board received this cash compensation in lieu of suspended equity grants in connection with the Merger, *given the uncertainty surrounding the Restatement*, supports a reasonable inference that the Board approved the Merger in order to receive that compensation" (emphasis added).

We note that the financial interests of the directors and the stockholders were aligned in obtaining the best price for the Company in a sale. The court viewed their interests in the *sale-no sale decision for the Company* as *not* aligned; however, we note, further, that their interests in the sale-no sale decision *could have been* aligned if the possibility of completing the Restatement and re-registering the Company's stock had been a reasonable possibility—as the equity awards also would have been monetized upon re-registration. The court's premise that there was *not* a reasonable possibility that the equity awards would ever have any value if the Company remained a standalone entity, and thus its conclusion that a sale was in the directors' self-interest because it monetized the equity awards, highlights that the court viewed the directors as, for whatever reasons, either unable or unwilling to ever complete the Restatement. That inability or unwillingness, the decision suggests, could have been based only on self-interested motives.

With respect to the "materiality" of the cash-out of the equity awards to the directors, the court stated in a footnote that there was a reasonable inference that the benefit received by each director was "significant enough in the context of the director's economic circumstances, as to have made it improbable that the director could perform [his or her] fiduciary duties to the shareholders without being influenced by [his or her] overriding personal interest." Six of the directors received $270,000 each in merger-related compensation through the immediate vesting of their equity awards, while one (the CEO) received $2.8 million. We note that the court's determination on this point was not based on consideration of each director's personal economic circumstances, but rather was inferred from the fact that the "[equity awards] for which the [directors] received cash compensation in the Merger constituted the only holdings that they had in the Company."

While the court found plaintiff's claims described above to be valid based on the unusual facts of the case, the court dismissed the following claims:

- ***Claim that the board acted in bad faith by engaging a financial advisor that it knew had done work for the buyer.*** The plaintiff alleged that (as disclosed in the proxy statement), after receiving Vector's indication of interest, which occurred years after the advisor's engagement with Saba began, the board was apprised of the advisor's prior relationship with Vector. The court found no reasonable inference that that the advisor's past relationship with Vector "was of such significance that it could not fairly and impartially advise the Board."

- ***Claim that the proxy statement should have disclosed more information about the financial advisor's services provided in the past to the buyer and its analyses underlying the fairness opinion.*** The plaintiff claimed that the proxy should have disclosed more information about services that the financial advisor to the Saba special committee had provided in the past two years to the buyer. The proxy disclosed that the advisor had provided "financing services" to an affiliate of Vector and had received "customary fees of approximately $1 million in connection with those services." Consistent with recent precedent, the court stated that what was material was the fact that there was a "prior working relationship" and the amount of fees (both of which had been disclosed), not "detail as to the specific services provided." The plaintiff also claimed that the proxy omitted important information relating to the banker's analyses performed to evaluate the fairness of the Merger price. Consistent with recent precedent, the court emphasized that a "full and fair" summary requires only that stockholders can understand the banker's analysis, not that they can "recreate" it, and that the disclosure of "minutiae" is not required.

- ***Claim that the CEO was motivated by continuing his employment after the Merger.*** The plaintiff contended that the Saba CEO ("F"), who led the sale process and the Merger negotiations for the Company, was "driven" by continuing his employment after the Merger. The court found that "[t]he Complaint lack[ed] any allegation that the CEO engaged in any employment negotiations prior to [Vector's] demand with any of the potential acquirors or that he was driven to take certain positions during the negotiations by a desire to be retained at the surviving corporation." Notably, Vector had demanded that it be permitted to negotiate a new employment contract with F as a condition to entering into the transaction; and F first negotiated employment terms with Vector five days before the Merger Agreement was signed, after the economic terms and due diligence had been finalized. Further, the court noted that this situation differed from one where it is "allege[d] that the CEO would lose his job unless he sold the company," or "where the CEO negotiating the transaction had a unique and personal need for liquidity that was not shared by all stockholders." F faced the same liquidity problem (caused by the pending deregistration of Saba's stock) as the other stockholders, the court stated.

- ***Claim that the buyer had "aided and abetted" the target directors' breaches*.** The plaintiff alleged that Vector acted with scienter (*i.e.*, that it knowingly aided the Saba directors in the breaches they allegedly committed)—by acquiring Saba at a price that Vector knew was unfair, as well as by "leveraging its position as a [prior] Saba lender armed with confidential information [(such as Saba's most recent and detailed financial information)] that other Saba stockholders did not possess." The court found that there was no aiding and abetting liability for the buyer because it had not "knowingly participated" in any breach by the Saba directors. While the court acknowledged that a bidder may not "knowingly create or exploit a fiduciary breach," it readily concluded that none of the facts pled supported a reasonable inference that Vector had done

"anything of the sort here." "The receipt of confidential information, without more, will not usually be enough to plead a claim of aiding and abetting," the court wrote. "Conclusory allegations" that a buyer received "too good of a deal," without more, also will be insufficient.

Practice Points

- **Consider all of the implications of unusual or unique facts.** The decision underscores that a board should consider all of the possible ramifications of any unusual or unique circumstances**—**including, for example, with respect to their impact on the appropriate timing of a sale. At the most basic level, a board should consider whether and how to resolve any obstacles presented by any unusual fact or circumstance. In addition**—**and particularly in light of the generally high bar for plaintiffs in making valid disclosure claims**—**special care should be taken to consider whether added disclosure is required in connection with any unusual or unique "factual development."

- **Consider whether the terms of equity awards skew the alignment of directors' and stockholders' interests.** If the Saba board had *not* favored a sale of the Company for self-interested reasons, the directors' equity awards could have been drafted to reflect that neutrality with respect to the sale-no sale decision by providing the same treatment for the awards (*i.e.*, conversion to cash payments) upon *either* a change of control *or* re-registration of the Saba stock. When crafting equity awards in the face of a potential transaction, a board should consider whether, under the specific circumstances, the provisions skew the alignment of directors' and stockholders' interests by creating an incentive to favor one strategic alternative, type of transaction, or specific transaction, over another.

- **A "coerced" vote is rare.** "Affirmative coercion"—*i.e.,* a board threatening that adverse consequences will occur if stockholders do not approve a proposed transaction—is rare. "Situational coercion" is even more unusual; however, a board should be attuned to the possibility where the stockholders have what could be viewed as a "Hobson's choice" between an unattractive transaction and an unattractive alternative. In such situations, the board should consider whether mitigation is possible and any disclosure implications. We note that a court may be influenced in such a situation by the additional option of seeking appraisal (although appraisal rights, while available to the Saba stockholders, were not mentioned in the *Saba* opinion).

- **Bringing disclosure claims post-closing.** In previous opinions, the court has emphasized that disclosure claims should be brought in a *pre-closing* action for injunctive relief (so that the remedy of supplemental disclosure is available, permitting a fully informed vote), rather than first being brought in a *post-closing* action for damages. In a footnote in the *Saba* opinion, however, the Vice Chancellor stated: "I am mindful that Plaintiff could have (but did not) seek to enjoin the Merger which is a preferred means to address serious disclosure claims in connection with a proposed transaction. Failing to pursue that remedy, however, does not deprive the Plaintiff of a right to press disclosure claims post-closing."

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