HUNTON& WILLIAMS

Client Alert

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Delaware Court Upholds Coercion and Disclosure Challenges to Merger – *Saba Software*

Since the Delaware Supreme Court's holding in *Corwin v. KKR Financial Holdings*, Delaware courts have solidified the principal that if a merger is approved by a majority of disinterested, fully informed and uncoerced stockholders, then the directors are entitled to the deferential protection of the business judgment rule (the "*Corwin* doctrine"). On March 31, 2017, however, the Delaware Court of Chancery, in *In re Saba Software, Inc.*,[1] found that a merger fell outside the protections of the *Corwin* doctrine. The court found that the complaint sufficiently alleged that the directors had violated their disclosure obligations and inequitably coerced stockholders to vote for the merger and, therefore, were not protected by the business judgment rule. This case, while unusual and fact-specific, is the first post-*Corwin* case to examine what might constitute actionable "coercion." It may also be particularly important for distressed companies whose stockholders are weighing a merger against an uncertain future.

Background

The Securities and Exchange Commission had previously filed a complaint alleging that one of Saba's foreign subsidiaries engaged in a fraudulent scheme that caused Saba to overstate its pretax earnings over a five-year period. After this came to light, Saba allegedly "assured its stockholders, regulators and the market that it would complete a restatement of its financial statements." Saba repeatedly failed "without explanation," however, to file a restatement, which led to Saba's being delisted from Nasdaq in 2013.

In 2014, after Saba's continued failure to restate its financials, Saba entered into a settlement agreement with the Securities and Exchange Commission, where Saba agreed to restate its historical financial statements by February 2015. Saba failed to restate its financials by the deadline and the SEC deregistered its stock, leaving Saba's stock virtually illiquid and depressing its value.

At the time Saba announced it would not be able to meet the restatement deadline, it also announced that it was considering strategic alternatives. Saba held discussions with numerous potential bidders and ultimately entered into a merger agreement with a private equity fund in February 2015. The merger was approved by the stockholders and completed in March 2015.

Court's Opinion

1. *The Business Judgment Rule was Inapplicable*

Under the *Corwin* doctrine, a majority vote of fully informed and uncoerced stockholders will "cleanse" a transaction and entitle directors to the protection of the business judgment rule. In *Saba*, however, Vice Chancellor Slights concluded that, at least at the pleading stage, the stockholder vote was not fully informed and that the stockholders were coerced into voting for the merger. As a result, the directors would be judged under *Revlon*'s enhanced scrutiny.

[1] *In re Saba Software, Inc. S'holders Litig.*, Consol. C.A. No. 10697-VCS, mem. op. (Del. Ch. Mar. 31, 2017).

(A) Disclosure Claims

The court rejected numerous disclosure claims challenging the proxy statement. These included claims that the proxy statement failed to provide all material information about Saba's internal financial projections, its financial advisor's analysis, and its financial advisor's relationship with the buyer. Two claims, however, were upheld in response to the defendants' motion to dismiss.

First, the court held that the complaint sufficiently alleged that the directors violated their disclosure obligations by not providing sufficient information about the company's ability to regain compliance with SEC rules and, therefore, register its stock again. The court observed that the proxy statement did disclose the company's projection that the restatement would be completed by August 2015 and also included the company's projected value on a standalone basis if the restatement were to be completed. In addition, the court recognized that the stockholders were clearly aware that the company had been unable to complete the restatement for almost three years. Nevertheless, the court stated that "unless the stockholders were armed with information that would allow them to assess the likelihood that Saba would ever complete a restatement of its financials, they would have no means to evaluate the choice they were being asked to make – accept merger consideration that reflected the depressed value caused by the Company's regulatory non-compliance or stay the course in hopes that the Company might return to the good graces of the SEC."

Second, the court held that the plaintiff had stated a claim that stockholders needed more information about the company's "post de-registration options" in lieu of the merger. The court acknowledged that, while Delaware law typically does not require such disclosure, "this is hardly a typical case given the deregistration of Saba's shares by the SEC just prior to the time the shareholder vote on the merger was to occur." The court said the deregistration had caused a "fundamental change to the nature and value of the stockholder's equity stake" and "dramatically affected the environment in which the Board conducted the sales process." The court thus concluded for pleading purposes that it was "reasonably conceivable" that stockholders, "[i]n considering whether or not Saba was viable as a going-concern without the Merger," needed more information "to understand what alternatives to the Merger existed."

(B) Coercion

The court also found that the complaint adequately alleged Saba's stockholders were coerced into supporting the merger. In making this finding, the court highlighted that the board allegedly "rushed the sales process" in the midst of regulatory uncertainty. It further observed that, "in voting on the Merger, Saba stockholders were given a choice between keeping their recently-deregistered, illiquid stock or accepting the Merger price of $9 per share, consideration that was depressed by the Company's nearly contemporaneous failure once again to complete the restatement of its financials." The court also explained that affirmative action by a fiduciary is not a prerequisite to wrongful coercion; rather, "inequitable coercion can exist… when the fiduciary fails to act when he knows he has a duty to act and thereby coerces stockholder action."

The court said that, by repeatedly failing to regain SEC compliance as alleged in the complaint, the board had failed to act in the face of a known duty to act. It continued that this failure could have created a coercive situation for stockholders: "it was not the Proxy's words or even its tone that created the coercion; the inequitable coercion flowed from the situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction."

2. Plaintiff Stated Claims for Breach of Fiduciary Duty

Having determined the directors were not protected by the business judgment rule, the court then concluded the plaintiffs adequately stated a claim for breach of the duty of loyalty. First, although calling the issue a “close call,” the court said the plaintiff alleged the directors acted in bad faith by repeatedly and inexplicably failing to complete the restatement and then rushing a sale process. Second, the court said the plaintiff alleged a breach of the duty of loyalty where the directors awarded themselves cash payments equal to suspended equity awards, which would otherwise have been adversely affected by the SEC’s deregistration. The board’s action was taken the day before the merger agreement was signed.

Take-Aways

The *Saba* case is important primarily because it is the first decision to analyze “coercion” under the *Corwin* doctrine. Traditionally, Delaware courts have defined coercion as causing stockholders to vote for a reason other than the merits of the transaction. Examples of coercion include threats of retribution or the fear of receiving less valuable consideration in a second-step transaction. In *Saba*, however, the court found that the coercion was the situation allegedly created by the board’s wrongful actions and inaction, which were not specifically associated with the terms of the merger. The court explained that coercion did not require “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.”

Delaware courts are unlikely to find actionable coercion with any frequency. Nearly every merger involves a trade-off: (1) accept the merger price or (2) pursue potentially more attractive alternatives, which may include operating as an independent company or pursuing a different transaction, and the associated risks. The fact that the company’s shares were deregistered and/or delisted should not, in itself, create inequitable coercion. In *Saba*, the court inferred “situationally coercive factors” based on very specific and detailed allegations in the complaint that, among other things, the board had repeatedly and inexplicably failed to restate the company’s financial statements over a prolonged period of time knowing it would result in deregistration that would materially impair the value and liquidity of the company’s stock.

An emerging issue under *Corwin* will be the intersection between disclosure and coercion. On the one hand, *Saba* said that “the forced timing of the Merger and the Proxy’s failure to disclose why the Restatement had not been completed… left the Saba stockholders staring into a black box…. with no practical alternative but to vote in favor of the Merger.” Likewise, the court observed that “the Proxy left stockholders in the dark… leaving them unable meaningfully to assess the value of Saba on a standalone basis.” On the other hand, the court said “it was not the Proxy’s words or even its tone that created the coercion; the inequitable coercion flowed from the situation in which the Board placed its stockholders as a consequence of its allegedly wrongful action and inaction.” Despite that statement, the question in future cases of whether stockholders have been coerced may often be closely intertwined with whether they have received enough information about the company’s prospects and value, and that such disclosure may preclude a finding of inequitable coercion.

In light of the above observations, *Saba* has the most implications for distressed companies pursuing sale transactions where the company needs to candidly communicate the company’s negative prospects to stockholders. Those companies will need to focus not just on presenting such information in a neutral, non-threatening manner, but also on providing all material information in context about the company’s overall situation.

Ultimately, *Saba* does not signal a shift in Delaware law. The opinion is based on a unique fact pattern and allegations. Moreover, even after finding that the business judgment rule did not apply, the court said it was a “close call” as to whether the plaintiffs actually pled a breach of fiduciary duty claim. To hold the directors liable, the plaintiffs will have to overcome an exculpatory clause at trial and prove a breach of the duty of loyalty.

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