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IN THE SUPREME COURT OF THE STATE OF DELAWARE

RAYMOND LEAL, YAOGUO PAN, and XIAOSONG HU, Defendants-Below, Appellants, v. PHILLIP MEEKS, ERNESTO RODRIGUEZ and ALAN HALL, Plaintiffs-Below Appellees.	)	No. 706, 2014 Case Below: Court of Chancery of the State of Delaware C.A. No. 7393-VCN

APPELLANTS' CORRECTED OPENING BRIEF

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NATURE OF PROCEEDINGS

In March 2012, Zhongpin Inc. ("Zhongpin" or the "Company") formed a special committee (the "Special Committee") in response to a going-private merger proposed by the Company's Chairman and CEO, Xianfu Zhu (the "Merger"). Less than a week later, Plaintiffs commenced this litigation.

Over the course of the next fifteen months, the Special Committee negotiated with Zhu and shopped the Company before determining that the Merger was in the best interests of the Company's unaffiliated stockholders; the Company's board of directors (the "Board") approved the Merger; and the holders of a majority of the Company's unaffiliated stock voted in favor of it.

Thereafter, in September 2013, Plaintiffs filed the operative complaint (the "Complaint"),[1] alleging that Zhu – who controlled no more than 26% of the Company's outstanding common stock – was a controlling stockholder and that the Merger was not entirely fair to the Company's unaffiliated public stockholders. Plaintiffs also alleged that the members of the Special Committee (the "Special Committee Directors") breached their fiduciary duties, but did not allege that those directors were grossly negligent, acted in bad faith, were interested in the Merger, or even that Zhu controlled them, as opposed to the Company. Instead, Plaintiffs alleged only that the Special Committee Directors were incentivized to approve the

[1] A copy of the Complaint is located in the Appendix at A15–A40.

Merger (and therefore were not independent) because they were compensated for their service on the Board and on the Special Committee – even though such compensation was not tied to their recommendation. Protected by a Section 102(b)(7) provision in the Company's charter, the Special Committee Directors moved to dismiss the Complaint for failure to state a non-exculpated claim against them.

The trial court denied the motion after concluding that Plaintiffs had sufficiently pled that Zhu was a controlling stockholder and that the Merger was not entirely fair. Relying solely on the Court of Chancery's decision in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*,[2] the trial court held that the allegations as to Zhu required it to deny the Special Committee Directors' motion to dismiss without assessing whether Plaintiffs had pled a non-exculpated claim against those directors.[3]

Upon timely application by the Special Committee Directors, the trial court certified its decision for interlocutory appeal. This Court accepted the interlocutory appeal by Order dated January 23, 2014.

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[2] 2014 WL 4418169 (Del. Ch. Sept. 10, 2014). As the trial court recognized in certifying its Memorandum Opinion and Order for interlocutory appeal, the *Cornerstone* decision upon which the trial court's decision relies is currently before this Court on interlocutory appeal.

[3] Copies of the Memorandum Opinion (the "Opinion" or "Op.") and implementing Order dated November 26, 2014 are attached hereto as Exhibit A and Exhibit B, respectively.

SUMMARY OF ARGUMENT

1. The trial court improperly held that Plaintiffs had stated a claim for breach of fiduciary duty against the Special Committee Directors without considering whether Plaintiffs pled any facts supporting an inference that those directors engaged in any non-exculpated conduct. The trial court erroneously believed that outcome was compelled by a *per se* rule that where a plaintiff sufficiently pleads facts supporting an inference that directors negotiated and approved a transaction with a controlling stockholder that was not entirely fair to the corporation, the loyalty and good faith of those directors is irrelevant.

By excusing plaintiffs from identifying the conduct of each defendant that gives rise to a specific claim against him, the trial court's decision contravenes established pleading standards. The *per se* rule applied below is premised on an incorrect reading of this Court's decisions in *Emerald Partners*. To the extent the *Emerald Partners* decisions could be construed to support the trial court's *per se* rule, it is inconsistent with Delaware law and policy, including the fundamental presumption that directors are faithful to their fiduciary duties, and should be overturned. The Opinion should be reversed and remanded for an assessment of whether Plaintiffs pled a cognizable, non-exculpated claim against the Special Committee Directors.

STATEMENT OF FACTS[4]

A. Zhu Approaches The Board And The Company Forms A Special Committee Of Independent Directors.

On March 27, 2012, Xianfu Zhu submitted a preliminary, nonbinding proposal to acquire Zhongpin's outstanding shares in a going-private transaction for $13.50 per share in cash. (Op. 2; A22; A90.) At the time, Zhu was the Chairman of the Board and Zhongpin's CEO, as well as its largest stockholder, owning approximately 17.3% of the Company's common stock.[5] (Op. 2, 5; A18.)

In his proposal, Zhu explained that he was interested only in acquiring the Company's outstanding stock and that he did not intend to sell his shares to a third party. He also noted that he would immediately commence discussions with potential sources of financing and might form agreements with other stockholders. (Op. 2–3; A22–23; A90–91.) Zhu conditioned his proposal on the approval of the Company's independent directors, but did not, at the outset, condition it on the approval of the majority of the Company's unaffiliated shares. (Op. 24; A90–91.)

The next day, the five-member Board responded by establishing a three-member Special Committee comprised of Raymond Leal, Yaoguo Pan, and Xiaosong Hu.[6] (Op. 3; A23; A97; A148.) The Board delegated full power and

[4] The facts are drawn from the Complaint (and documents incorporated therein).

[5] Zhongpin is a Delaware corporation primarily engaged in the meat and food processing and distribution business in China.

[6] The other member of the Board, Baoke Ben, was an interested participant in the Merger.

authority to the Special Committee to (a) review and negotiate the terms of the proposal or any alternative transaction; (b) advise the Board whether the proposal or any alternative transaction was advisable and fair to the Company and its unaffiliated stockholders; and (c) reject or approve, or recommend rejection or approval, of Zhu's proposal or any alternative transaction. (Op. 3; A23; A148.) The Board agreed it would proceed only with a favorable recommendation from the Special Committee. (A148.)

For their service, the Special Committee Directors received an up-front fee plus a monthly stipend until either the effective time of the Merger or until the fees equaled a cap. This compensation was not contingent upon the completion of the Merger or the Special Committee's recommendation of the Merger. (Op. 4–5; A33; A198.) No member of the Special Committee is alleged to have had an interest in the Merger, or to have retained any role in post-Merger Zhongpin. Nor are there any allegations that Zhu nominated any of the Special Committee Directors to the Board, or otherwise exercised domination or control over them. (Op. 13.)

B. The Special Committee Explores Alternative Transactions And Successfully Negotiates For Significant Stockholder-Protective Provisions.

Following its formation, the Special Committee retained independent financial and legal advisors. (Op. 5 & n.5; A15; A23; A97.) For the next several months, the Special Committee met frequently and actively responded to changing conditions, including materially lowered management projections. (*See* Op. 5–8; A23–27; A148–57.) The Special Committee successfully acquired significant protections for the Company and its unaffiliated stockholders, including:

- The Special Committee convinced Zhu not to enter any exclusivity arrangements with potential investors and to remain open to partnering with interested third parties, to which he initially agreed. (Op. 7; A25–26; A152.)
- The Special Committee conducted a market check, led by its financial advisor, who contacted twenty-two potential acquirers, including seventeen private equity firms and five potential strategic buyers, with five interested parties executing confidentiality agreements. (Op. 7; A26; A153–54.)
- The Special Committee convinced Zhu to modify his offer to include: (i) a nonwaivable condition that the transaction be approved by a majority of the unaffiliated shares, (ii) a 60-day go-shop provision, and (iii) the grant of a right to Zhongpin to terminate the merger agreement *at any time* and *for any reason* during the go-shop period without payment *of any termination fees to Zhu*. (Op. 9; A29–31; A155–57.)

C. The Special Committee And Board Approve The Merger Agreement.

Following months of negotiations, the Special Committee approved an agreement and plan of merger (the "Merger Agreement") on November 26, 2012. The Special Committee, notwithstanding that its financial advisor terminated its engagement without rendering a fairness opinion, determined that it was in the unaffiliated stockholders' best interests to move forward, as it concluded that any further delay in signing the Merger Agreement would put Zhu's financing at risk and jeopardize the entire transaction. The Special Committee also concluded that the proposal was fair and in the best interests of the Company's unaffiliated stockholders and preferable to continuing as a stand-alone company. (Op. 9; A161–64.) In reaching that conclusion, the Special Committee considered:

- *Price*: Zhu's proposed consideration of $13.50 per share represented a 47% premium over the closing price on March 26, 2012, the last trading day prior to the announcement of Zhu's proposal. (*See* A90; A158.)

- *Downward Projections*: With the assistance of its advisors, the Special Committee considered the material decrease in the Company's prospects that arose after Zhu's proposal. (*See* Op. 7; A158.)

- *Stockholder-Protective Conditions*: The Special Committee successfully negotiated for a majority of the unaffiliated shares voting condition. (*See* Op. 1; A164; A277 § 7.1 (referencing definition in A257 § 3.3(c)).)

- *Retained Flexibility*: The go-shop provision and termination rights contained in the Merger Agreement preserved flexibility by allowing the Company, at the direction of the Special Committee, to continue to seek alternatives and to terminate the agreement (with no penalty), if an agreement could be reached with another bidder. (Op. 9; A158.)

Shortly after signing the Merger Agreement, the Special Committee retained two new independent financial advisors who launched the go-shop process, contacting fifty-five private equity firms and twenty-eight strategic investors to solicit interest in a possible alternative transaction. (Op. 10; A29–30; A159.) Although the Special Committee later negotiated an extension to the go-shop period (with a concomitant extension allowing the Company to terminate the Merger Agreement for any reason with no termination fee), the Company received no superior offers. Following the termination of the extended go-shop period, both advisors opined that the Merger consideration was fair from a financial point of view to the unaffiliated stockholders. (Op. 10–11; A31; A160.)

On February 8, 2013, the Special Committee recommended that the Board approve the terms of an amended merger agreement that removed the go-shop provision and reset the termination fees payable by the Company. The Board approved the amended merger agreement later the same day. The holders of a majority of the unaffiliated shares voted to approve the amended merger agreement on June 27, 2013. The Merger closed the same day. (Op. 11; A17; A31; A160.)

D. Plaintiffs Challenge The Merger.

Plaintiffs first sued on April 3, 2012, one week after public disclosure of Zhu's proposal. Approximately one year later, Plaintiffs began efforts to consolidate the action and appoint lead counsel, which occurred in late July 2013. The Complaint was filed two months later, on September 16, 2013.

The Complaint alleges that Zhu was a controlling stockholder and that Plaintiffs are entitled to damages because the Merger was not entirely fair to the Company's unaffiliated public stockholders. The Complaint also directs one count at the Special Committee Directors, alleging that they breached their fiduciary duties by engaging in a sales process that avoided competitive bidding and advantaged Zhu. (Op. 11–12; A38–39.) Conceding that the Special Committee Directors were not interested in the Merger, Plaintiffs attempt to support their claim against them by arguing that the compensation they received as directors, and for serving on the Special Committee, supports the conclusion that they were not independent. (*See* Op. 13; A33–35.)[7]

On September 27, 2013, the Special Committee moved to dismiss the Complaint because it did not allege that any member of the Special Committee breached a non-exculpated duty, and because Delaware law rejects Plaintiffs' sole compensation-based theory as insufficient to support an inference that the directors breached their duty of loyalty.[8] (A41; A68–77.) Zhu and Ben also moved to dismiss, arguing that Zhu was not a controlling stockholder.

After the defendants filed their separate opening briefs, the parties agreed to stay briefing pending the decision in *Kahn v. M & F Worldwide Corp.*[9] Briefing re-commenced on April 7, 2014.

E. The Trial Court Denies The Special Committee's Motion To Dismiss Without Examining Whether The Complaint Alleges A Non-Exculpated Claim.

On November 26, 2014, the trial court denied the Special Committee Directors' motion to dismiss on the sole basis that Plaintiffs had sufficiently pled

7 The Complaint does not allege that any of the Special Committee Directors was grossly negligent, acted in bad faith, or was interested in the Merger.

8 The motion further explained the counter-intuitive nature of such an argument, as the Special Committee Directors would be, if anything, financially incentivized to reject the Merger because its consummation meant the loss of their directorships and between $30,000 and $45,000 in annual director fees. (A72.)

9 88 A.3d 635 (Del. 2014).

facts "raising an inference that Zhu was a controller and that the transaction was not entirely fair to the unaffiliated stockholders."[10] (Op. 28–29.) In doing so, the trial court acknowledged that it had not considered whether Plaintiffs pled facts which could raise an inference that the Special Committee Directors were not independent "[b]ecause of its irrelevance to this analysis." (Op. 28 n.57.)

The trial court's decision relied extensively on *In re Cornerstone Therapeutics Inc. Stockholder Litigation*,[11] which in turn cited to this Court's 2001 decision in *Emerald Partners v. Berlin*.[12] (*See* Op. 27–28.) In citing *Cornerstone*, the trial court noted that, in that case, the Court of Chancery had "questioned the merit of forcing disinterested directors to face the same pleading standard as interested fiduciaries in cases subject to entire fairness" but concluded that its "examination of precedent left it with no other choice." (Op. 28–29 (citing *Cornerstone*, 2014 WL 4418169, at *10–12).)

10 That conclusion was based on the Company's March 18, 2013 Form 10-K, which described Zhu as the Company's "controlling shareholder" due to his "significant influence" over the Company through stockholder approvals for the election of directors and day-to-day management. (*See* Op. 17–21.)

11 2014 WL 4418169 (Del. Ch. Sept. 10, 2014).

12 787 A.2d 85 (Del. 2001) ("*Emerald Partners II*").

ARGUMENT

Question Presented

Assuming Plaintiffs allege facts supporting only an inference that a controlling stockholder entered into a self-interested transaction that was not entirely fair, does a trial court err by refusing to dismiss a money damages claim against disinterested directors who negotiated and approved the transaction regardless of whether they engaged in any non-exculpated conduct?

This issue was preserved below. (A68–77 (Op. Br. in Supp. of Mot. to Dismiss); A492–503 (Reply Br. in Supp. of Mot. to Dismiss); A540–43 (Hr'g Tr.); Op. 26–29).

Scope of Review

This Court reviews a trial court's ruling on a motion to dismiss *de novo* to "determine whether the trial judge erred as a matter of law in formulating or applying legal precepts."[13]

Merits of Argument

The trial court's opinion rests on a rule of decision erroneously derived from this Court's decision in *Emerald Partners II*. Under the rule applied by the trial court, a plaintiff states a breach of fiduciary duty claim against disinterested directors who approve a transaction solely on the basis that an

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13 *Gantler v. Stephens*, 965 A.2d 695, 703 (Del. 2009) (quoting *Feldman v. Cutaia*, 951 A.2d 727, 730–31 (Del. 2008)).

allegedly controlling stockholder entered into a transaction that did not meet the requirements of *M & F Worldwide*, and without pleading any facts supporting an inference that the directors engaged in any non-exculpated conduct. That rule has never been approved by this Court – either in its *Emerald Partners* decisions or otherwise – and should not be affirmed. The trial court's decision is premised on an incorrect reading of this Court's precedent and must be reversed and remanded for an assessment of whether Plaintiffs alleged facts supporting an inference of a non-exculpated claim against the Special Committee Directors.

I. THE TRIAL COURT ERRED BY HOLDING THAT PLAINTIFFS STATED A CLAIM AGAINST THE SPECIAL COMMITTEE SOLELY BASED ON THE ALLEGATIONS THAT ZHU CONTROLLED THE COMPANY AND THAT THE MERGER WAS NOT ENTIRELY FAIR.

In cases where a controlling stockholder stands on both sides of a transaction, it is well established that the "*controlling or dominating shareholder proponent of the transaction* bears the burden of proving its entire fairness."[14] This Court, however, has never permitted a plaintiff to bootstrap a breach of loyalty claim against a controlling stockholder into a loyalty claim against disinterested directors approving such a transaction, as Plaintiffs attempt to do here. Even where a plaintiff has sufficiently pled facts supporting an inference that a controlling stockholder stood on both sides of an unfair transaction, a plaintiff

[14] *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1117 (Del. 1994) (emphasis added); *accord Rosenblatt v. Getty*, 493 A.2d 929, 937 (Del. 1985); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del.1983).

states a breach of fiduciary duty claim against directors who approve the transaction only when the plaintiff sufficiently alleges that those directors – on a separate and individualized basis – engaged in non-exculpated conduct.

The pleading standards in the Court of Chancery Rules support this conclusion.[15] When a complaint names numerous defendants, a plaintiff must identify the conduct of each defendant that gives rise to a specific claim against that defendant, in order to provide fair notice to each defendant of the wrong alleged.[16] If a complaint fails to state a claim against certain defendants, the trial court must dismiss the complaint "without the need for the defendants to file an answer and without proceeding with discovery."[17]

On several occasions, this Court has explained the proper application of the pleading standards in the context of breach of fiduciary duty claims against both directors and controlling stockholders. Those decisions begin with the "key principle . . . that the directors [of a Delaware corporation] are entitled to a

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[15] Ct. Ch. R. 8(a); *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001).

[16] *See Steinman v. Levine*, 2002 WL 31761252, at *15 & n.81 (Del. Ch. Nov. 27, 2002) (holding that a plaintiff "is required to identify specific acts of individual defendants for his . . . claim to survive."), *aff'd*, 822 A.2d 397 (Del. 2003); *Shandler v. DLJ Merchant Banking, Inc.*, 2010 WL 2929654, at *12 (Del. Ch. July 26, 2010) (assessing allegations against six directors to separately determine whether complaint stated non-exculpated claim for relief). *See generally* 5 Charles A. Wright & Arthur R. Miller, *Federal Practice & Procedure* § 1248 (3d ed. 2004) ("[I]n order to state a claim for relief, actions brought against multiple defendants must clearly specify the claims with which each particular defendant is charged").

[17] *Malpiede*, 780 A.2d at 1094; *accord* Ct. Ch. R. 12(b)(6); *see, e.g.*, *DiRienzo v. Lichtenstein*, 2013 WL 5503034, at *1 (Del. Ch. Sept. 30, 2013).

presumption that they were faithful to their fiduciary duties."[18] Stating a claim for breach of fiduciary duty, therefore, requires a plaintiff to overcome the "presumption that in making a business decision the directors . . . acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."[19] Only where a plaintiff sufficiently alleges that the directors approving the decision committed either a breach of the duty of loyalty or a non-exculpated breach of the duty of care will the plaintiff rebut the business judgment rule's presumption and shift the burden to those directors to establish that the transaction they approved was entirely fair to the company.[20]

A different standard, however, applies to a controlling stockholder standing on both sides of a transaction.[21] Because of her divided loyalties, absent the presence of certain procedural protections, "[a] controlling or dominating stockholder standing on both sides of a transaction . . . bears the burden of proving

[18] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004).

[19] *Gantler*, 965 A.2d at 705–06 (Del. 2009) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162–64 (Del. 1995).

[20] *See Malpiede*, 780 A.2d at 1094 & n.65.

[21] *See Citron v. E.I. DuPont de Nemours & Co.*, 584 A.2d 490, 498–502 (Del. Ch. 1990) (discussing entire fairness standard that applies to controlling stockholders standing on both sides of a going-private merger and business judgment standard that applies to the special committee approving the transaction).

its entire fairness."[22] Thus, a plaintiff typically can state a claim for breach of fiduciary duty against a controlling stockholder by pleading facts raising an inference that the stockholder controls the board of directors, stood on both sides of the transaction, and that the transaction was not entirely fair to the minority.[23]

This Court's decisions regarding controlling stockholder transactions have carefully avoided conflating the pleading standards applicable to directors and controlling stockholders, and have never held directors to an entire fairness standard solely on the basis that they negotiated or approved a transaction with a controlling stockholder. To the contrary, this Court has consistently held that "[t]he initial burden of establishing entire fairness rests upon *the party who stands on both sides of the transaction*."[24] In articulating that standard, this Court has never held that directors who approve the transaction – in the absence of any well-pled allegations that those directors also breached their fiduciary duty of loyalty – nonetheless will be jointly and severally liable if the stockholder-fiduciary does not prove the transaction was entirely fair. By way of example, this Court's decision

[22] *Lynch*, 638 A.2d at 1115; *see also Kahn v. M & F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) (describing procedural protections).

[23] *Monroe Cnty. Emps. Ret. Sys. v. Carlson*, 2010 WL 2376890, at *2 (Del. Ch. June 7, 2010).

[24] *Lynch*, 638 A.2d at 1117 (emphasis added); *see also, e.g., id.* ("It is a now well-established principle . . . that in an interested merger, the controlling or dominating shareholder proponent of the transaction bears the burden of proving its entire fairness."); *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710–11 (Del. 1983) ("The requirement of fairness is unflinching in its demand that where one stands on both sides of a transaction, he has the burden of establishing its entire fairness . . . ."); *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107, 110 (Del. 1952) ("Since [the majority stockholder] stands on both sides of the transaction, they bear the burden of establishing its entire fairness . . . .").

in *Kahn v. Tremont Corp.*,[25] applying the entire fairness standard to all defendants, including the special committee, must be viewed in the context in which the appeal arose. The decision on appeal was a *post-trial decision*, in which the trial court had determined that entire fairness would apply to all defendants, in part because it found that the plaintiff had sufficiently pled facts calling into question the disinterestedness and independence of the directors comprising the special committee.[26]

There is good reason for distinguishing the two standards. Put simply, the entire fairness test is "an inquiry designed to assess whether a self-dealing transaction should be respected or set aside in equity. It has only a crude and potentially misleading relationship to the liability any particular fiduciary has for involvement in a self-dealing transaction."[27] The standard works for a controlling stockholder who stands on both sides of the transaction because the controller's subjective good faith is irrelevant – the controller is by definition interested in the transaction and therefore breaches the duty of loyalty if the transaction is unfair.[28]

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[25] 694 A.2d 422, 428 (Del. 1997).

[26] *See Kahn v. Tremont Corp.*, 1994 WL 162613, at *3–5 (Del. Ch. Apr. 22, 1994).

[27] *Venhill Ltd. P'ship v. Hillman*, 2008 WL 2270488, at *22 (Del. Ch. June 3, 2008).

[28] *See id.* ("[T]he central insight of the entire fairness test . . . is that when a fiduciary self-deals he might unfairly advantage himself even if he is subjectively attempting to avoid doing so."); *see also In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, C.A. No. 961-VCS, at 41 (Del. Ch. Dec. 21, 2010) (TRANSCRIPT) ("That is the part about being the interested party. Your subjective good faith is not really at issue; you are the interested party.").

But "[t]he entire fairness standard ill suits the inquiry whether *disinterested directors* who approve a self-dealing transaction and are protected by an exculpatory charter provision . . . can be held liable for breach of fiduciary duties."[29] As the Court of Chancery explained in dismissing special committee directors at the summary judgment stage in *In re Southern Peru Copper Corp. Shareholder Derivative Litigation*, the facts that suffice to state a claim against an interested controlling stockholder are distinct from those that suffice to state a claim against disinterested special committee directors who do not stand on both sides of the transaction:

> Unless there are facts suggesting that the directors consciously approved an unfair transaction, the bad faith preference for some other interest than that of the company and the stockholders that is critical to disloyalty is absent. The fact that the transaction is found to be unfair is of course relevant, but hardly sufficient, to that separate, individualized inquiry. In this sense, the more stringent, strict liability standard applicable to interested parties . . . is critically different than that which must be used to address directors such as those on the Special Committee.[30]

Several decisions from the Court of Chancery have declined to strip special committee members of the presumption that they complied with their fiduciary duties based only on the conduct of a controlling stockholder and without

[29] *In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, 52 A.3d 761, 787 n.72 (Del. Ch. 2011), *aff'd sub nom. Ams. Mining Corp. v. Theriault*, 51 A.3d 1213 (Del. 2012); *accord Venhill Ltd. P'ship*, 2008 WL 2270488, at *22.

[30] *Southern Peru*, 52 A.3d at 787 n.72.

considering whether the directors comprising the committee separately engaged in non-exculpated conduct warranting entire fairness review of their actions.[31] In a decision cited with approval by this Court in *Kahn v. Lynch*, the Court of Chancery declined to review the conduct of a disinterested and independent special committee under the entire fairness standard, despite holding the controlling stockholder that stood on both sides of the transaction to that heightened standard.[32]

Here, the trial court disregarded the pleading standards and denied the Special Committee Directors' motion to dismiss without considering whether the Complaint alleged that each of those disinterested directors engaged in non-exculpated breaches of fiduciary duty that would subject their actions to entire fairness review. This approach improperly allowed Plaintiffs to "bootstrap" a breach of loyalty claim against a controlling stockholder into a claim against the

[31] *See DiRienzo*, 2013 WL 5503034, at *10-11 (applying business judgment standard to dismiss disinterested and independent special committee that approved interested transaction with controlling stockholder notwithstanding that entire fairness standard applied to controlling stockholder); *In re BHC Commc'ns S'holder Litig.*, 789 A.2d 1, 4–7, 9–14 (Del. Ch. 2001) (applying business judgment standard to dismiss disinterested and independent special committees that approved transactions that diverted disproportionate value to controlling stockholder notwithstanding that entire fairness standard applied to controlling stockholder); *O'Reilly v. Transworld Healthcare, Inc.*, 745 A.2d 902, 914 (Del. Ch. 1999) (concluding that directors approving interested transaction with a controlling stockholder could be dismissed at motion to dismiss stage pursuant to a Section 102(b)(7) defense where the factual basis for a claim for breach of fiduciary duty against them solely implicates the duty of care).

[32] *Citron*, 584 A.2d at 499–500. *Citron* was the last in a series of Court of Chancery decisions that split over the effect that the approval of a cash-out merger by a special committee of disinterested directors had upon the controlling or dominating stockholder's burden or demonstrating entire fairness. This Court resolved those "different views" in *Kahn v. Lynch*, adopting the approach followed in *Citron* that such approval "shifts the burden of proof on the issue of fairness *from the controlling or dominating shareholder* to the challenging shareholder-plaintiff." 638 A.2d at 1117 (emphasis added). In so holding, this Court relied almost exclusively on the policy rationale articulated by the Court of Chancery in *Citron*. *Id.* at 1116–17 (quoting *Citron*, 584 A.2d at 502).

Special Committee.[33] This Court should remand and instruct the trial court to engage in an assessment of whether the Complaint sufficiently states a non-exculpated claim against each of the Special Committee Directors for breach of fiduciary duty separate and apart from its assessment of whether the Complaint asserts claims against Zhu.

33 *DiRienzo*, 2013 WL 5503034, at *11.

II. *EMERALD PARTNERS II* DOES NOT CONTROL AT THE PLEADING STAGE.

Contrary to the trial court's view, this Court's decisions in *Emerald Partners* do not mandate a denial of the motion to dismiss. In *Cornerstone*, which was cited by the trial court in this matter, the Court of Chancery expressed its belief that this Court's holding in *Emerald Partners II* rendered it unnecessary, in the context of a controlling stockholder transaction, to assess whether a plaintiff has sufficiently alleged that disinterested directors engaged in non-exculpated conduct. The Court of Chancery based its erroneous belief on this Court's statement that, "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided."[34] The trial court's reliance on this Court's discussion of *post-trial* evidentiary burdens is inappropriate and fails to consider that language in its proper context.[35] Indeed, a closer look at the full context of *Emerald Partners II* shows the statement is not as broad as the *Cornerstone* court believed, and should not control at the pleading stage.

[34] *Cornerstone*, 2014 WL 4418169, at *12 (quoting *Emerald Partners II*, 787 A.2d at 94).

[35] *See In re MFW S'holders Litig.*, 67 A.3d 496, 524 (Del. Ch. 2013) ("this [broad language], like all judicial language, needs to be read in full context, as our Supreme Court itself has emphasized." (citing *Sternberg v. O'Neil*, 550 A.2d 1105, 1116 (Del.1988); *Rabkin v. Philip A. Hunt Chem. Corp.*, 498 A.2d 1099, 1104 (Del. 1985))).

A. *Emerald Partners I* Reversed Summary Judgment Due To Factual Questions About The Director Defendants' Loyalty.

The plaintiffs in *Emerald Partners* brought derivative and class action claims following a corporation's merger with its controlling stockholder. The complaint alleged, among other things, that the merger was not entirely fair and that the director defendants had committed disclosure violations in the company's proxy statement. The defendants did not move to dismiss, but moved for summary judgment post-discovery. The Court of Chancery granted the motion, concluding that the alleged disclosure violations at issue involved (at most) a breach of the duty of care, and that the defendants were therefore exculpated from liability under the company's Section 102(b)(7) charter provision.

This Court reversed in *Emerald Partners I*, holding that the plaintiffs had "made a sufficient showing through factual allegations that entire fairness should be the standard by which the directors' actions are reviewed."[36] This Court noted several factual issues implicating the non-affiliated directors' duty of loyalty, including:

(1) the controlling stockholder's and an affiliated director's improper participation in the deliberations of the 'non-affiliated' directors;

(2) the controlling stockholder's improper contact with the non-affiliated directors' financial advisor;

(3) their complete lack of negotiation of the merger's exchange ratio;

[36] *Emerald Partners v. Berlin*, 726 A.2d 1215, 1222 (Del. 1999) ("*Emerald Partners I*").

(4) the utter disregard for the committee process; and

(5) their failure to seek an updated fairness opinion.[37]

The plaintiff also argued that the proxy statement misrepresented material facts about the merger negotiation process.[38] As a result, the Court held that the defendants could not invoke the Section 102(b)(7) provision at that stage of the proceedings because "the entire fairness and disclosure claims under these circumstances were intertwined and should not have been separately considered."[39] Accordingly, the Court remanded for a trial under an entire fairness standard of review.

In doing so, the Court explained that, consistent with *Kahn v. Lynch*, the presence of a controlling stockholder standing on both sides of the transaction was "sufficient to require the demonstration of entire fairness."[40] However, the Court felt compelled to separately note that "a breach of any one of the board of directors' . . . fiduciary duties . . . sufficiently rebuts the business judgment presumption and permits a challenge to the board's action under the entire fairness standard."[41] In short, the lingering questions of fact regarding the disclosure

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[37] *Id.* at 1220 n.5; *see also id.* at 1223 (noting disclosure claims were not "due care claims").

[38] *Id.* at 1222.

[39] *Id.*

[40] *Id.* at 1221 n.8.

[41] *Id.* at 1221.

claims, which related to issues of the directors' loyalty, subjected the non-affiliated directors' conduct to entire fairness review, not the mere presence of a controlling stockholder on both sides of the transaction.

Nor did the Court categorically preclude pre-trial application of a Section 102(b)(7) provision in all cases, clarifying that "where the factual basis for a claim *solely* implicates a violation of the duty of care, this Court has indicated that the protections of such a charter provision may properly be invoked and applied."[42] Two years later, this Court confirmed this proposition, holding that, at the pleading stage, the plaintiff bears the burden of alleging "well-pleaded facts stating a claim on which relief may be granted" and, absent "well-pleaded facts supporting a breach of loyalty or bad faith claim," a complaint against directors protected by a Section 102(b)(7) defense must be dismissed.[43]

In sum, this Court in *Emerald Partners I* reversed at the summary judgment stage because facts in the record created a genuine issue regarding whether the non-affiliated directors had breached their non-exculpated duty of loyalty. Those factual questions, which arose in a disclosure claim, were intertwined with factual issues about whether the transaction was entirely fair.[44]

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[42] *Id.* at 1224.

[43] *Malpiede v. Townson*, 780 A.2d 1075, 1094 (Del. 2001).

[44] *Emerald Partners I*, 726 A.2d at 1222.

B. *Emerald Partners II* Requires An Entire Fairness Analysis Before Applying A Section 102(b)(7) Defense Only When There Is An Issue Of Loyalty Against Individual Directors That Must Be Resolved At Trial.

On remand, the Court of Chancery held a trial and, instead of engaging in an entire fairness analysis, determined that the directors had at most breached a duty of care and, accordingly, were exculpated from liability.[45] In doing so, the court acknowledged that the directors' decision-making process had not been a "model of procedural perfection," but found the director defendants had shown they had not breached their duties of loyalty or good faith.[46]

This Court again reversed in *Emerald Partners II*, holding that the Court of Chancery had prematurely analyzed the impact of the Section 102(b)(7) charter provision.[47] The Court – in language later relied upon by the Court of Chancery in *Cornerstone* and the trial court in this action – observed that "when entire fairness is the applicable standard of judicial review, a determination that the director defendants are exculpated from paying monetary damages can be made only *after the basis* for their liability has been decided."[48] But that language cannot be separated from its context. Specifically, this Court had earlier found in *Emerald Partners I* that the plaintiff had made a sufficient showing through the

[45] *Emerald Partners v. Berlin*, 2001 WL 115340, at *19 (Del. Ch. Feb. 7, 2001).

[46] *Id.* at *6, *25–26.

[47] *Emerald Partners II*, 787 A.2d 85, 96–97 (Del. 2001).

[48] *Id.* at 94.

factual record to trigger entire fairness review of the directors' actions. That finding was not based on the mere presence of a controlling stockholder standing on both sides of the transaction, but on the plaintiff's showing that the disclosure claims asserted against the directors, including a misrepresentation that there were arm's-length negotiations, were intertwined with factual issues about whether the transaction was entirely fair, which implicated the directors' duty of loyalty.

Emerald Partners II did not change the legal landscape. Even in controlling stockholder buyout transactions, directors are entitled to business judgment review absent a procedurally-appropriate showing that they have an interest in the transaction or breached their duty of loyalty.[49] Only after such a showing is made is it inappropriate to consider the exculpatory effect of a Section 102(b)(7) charter provision before applying the entire fairness standard.

C. Delaware Decisions Demonstrate That *Emerald Partners* Does Not Extend To Pleading Issues And Is Not Controlling.

As this Court emphasized in *Malpiede v. Townson,*[50] the procedural posture of the *Emerald Partners* decisions is also critical to understanding their holdings. In *Malpiede* – decided shortly after *Emerald Partners I* – this Court affirmed the dismissal of duty of loyalty and bad faith claims against directors at

49 *See Citron*, 584 A.2d at 499.

50 780 A.2d 1075, 1094 (Del. 2001).

the motion to dismiss stage because the complaint did not plead a non-exculpated breach of duty. Although *Malpiede* did not involve a controlling stockholder transaction, this Court nevertheless carefully distinguished *Emerald Partners I* based on its procedural posture:

> The procedural posture here is quite different from that in *Emerald Partners.* There the Court stated that it was incorrect for the trial court to grant summary judgment on the record in that case because the defendants had the burden *at trial* of demonstrating good faith if they were invoking the statutory exculpation provision. In this case, we focus not on trial burdens, but only on pleading issues. A plaintiff must allege well-pleaded facts stating a claim on which relief may be granted. Had plaintiff alleged such well-pleaded facts supporting a breach of loyalty or bad faith claim, the Section 102(b)(7) charter provision would have been unavailing as to such claims, and this case would have gone forward.[51]

Later opinions from the Court of Chancery echo the recognition that the *Emerald Partners* decisions dealt with trial burdens and did not do away with the requirement that plaintiffs plead facts sufficient to state a non-exculpated claim against disinterested directors.[52] Most recently, in *DiRienzo v. Lichtenstein,*[53] the court granted a special committee's motion to dismiss in circumstances similar to this case, as it involved a special committee that negotiated with a controlling stockholder. In doing so, the Court of Chancery rejected the argument that

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[51] *Id.* (footnote omitted).

[52] *See supra* note 31.

[53] 2013 WL 5503034, at *1, 10–11 (Del. Ch. Sept. 30, 2013).

Emerald Partners II foreclosed the possibility of dismissing the special committee directors, explaining that *Emerald Partners II* made its oft-quoted statement only "after it had been decided that the directors' actions were subject to entire fairness review."[54] Hence, the directors in *Emerald Partners* could not employ their 102(b)(7) defense by "virtue of their conduct, not because the transaction was subject to entire fairness review for other reasons."[55]

In short, *Cornerstone* misconstrued this Court's decisions in *Emerald Partners I* and *II*, and the trial court's subsequent reliance on *Cornerstone* was legal error. In those decisions, this Court undertook an inquiry into whether the plaintiff had made a procedurally-appropriate showing that the directors had an interest in the transaction or otherwise breached their duty of loyalty. That inquiry alone distinguishes the *Emerald Partners* decisions from this case, where the trial court denied the Special Committee Directors' motion to dismiss without considering whether those directors engaged in any non-exculpated conduct. As this Court explained in *Malpiede*, *Emerald Partners* addressed trial burdens; it did not change the rule that a plaintiff must allege well-pleaded facts stating a claim upon which relief may be granted. To the extent that this Court determines *Emerald Partners II* stands for a broader principle, it should be overturned.

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[54] *Id.* at *11.

[55] *Id.*

III. REQUIRING THE TRIAL COURT FIRST TO CONSIDER WHETHER A PLAINTIFF HAS SUFFICIENTLY PLED A NON-EXCULPATED CLAIM AGAINST DISINTERESTED DIRECTORS CONFORMS TO FUNDAMENTALS OF DELAWARE LAW.

Requiring a plaintiff to plead a cognizable, non-exculpated claim against disinterested directors who negotiate and approve a transaction with a controlling stockholder is consistent with Delaware law and policy. A key principle of Delaware corporate law is that "directors are entitled to a *presumption* that they were faithful to their fiduciary duties."[56] This presumption rests on the understanding that directors are motivated to exercise their independent judgment by a variety of factors, including "personal integrity, honesty, concern about their business reputations, and the threat of liability to shareholders."[57]

Indeed, as the Court of Chancery explained in *In re MFW Shareholders Litigation*,[58] considerations such as reputational embarrassment and modern technology, with the latter enabling the advisors of institutional investors to track decisions made by individual directors, provide a further incentive for directors to acquire favorable deals for minority stockholders:

> [M]ost directors will want to procure a deal that their minority stockholders think is a favorable one, and virtually all will not want to suffer the reputational

[56] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004) (citing *Aronson*, 473 A.2d at 812).

[57] *Id.* at 1052 n.32 (citing Bryan Ford, *In Whose Interest: An Examination of the Duties of Directors and Officers in Control Contests*, 26 ARIZ. ST. L.J. 91, 127 (1994)).

[58] 67 A.3d 496 (Del. Ch. 2013).

> embarrassment of repudiation at the ballot box. That is especially so in a market where many independent directors serve on several boards, and where institutional investors and their voting advisors, such as ISS and Glass Lewis, have computer-aided memory banks available to remind them of the past record of directors when considering whether to vote for them or withhold votes at annual meetings of companies on whose boards they serve.[59]

The trial court's *per se* rule ignores both the traditional protections afforded to directors by the business judgment rule and this more modern reality of activist institutional stockholders that reward and discipline directors' decision-making. By adopting an automatic inference that disinterested directors would risk their reputations, future income from service on other corporate boards, and potential liability to stockholders by disregarding their fiduciary obligations and rubber-stamping a controlling stockholder transaction, the trial court's rule creates a "dubious presumption" that a disinterested director would "sell his or her soul" for a controlling stockholder.[60]

For three decades, this Court has emphasized the importance of independent directors in safeguarding the interests of stockholders because they preserve the integrity of the corporate governance process. In 1983, in *Weinberger*

[59] *Id.* at 529 (footnotes omitted).

[60] E. Norman Veasey, *The Defining Tension in Corporate Governance in America*, 52 BUS. LAW. 393, 406 (1997).

v. UOP, Inc.,[61] this Court highlighted the benefits of an independent negotiating structure, explaining that the outcome of the case "could have been entirely different if [the corporation] had appointed an independent negotiating committee of its outside directors to deal with [its majority owner] at arm's length." Eleven years later, in *Kahn v. Lynch*,[62] this Court allowed defendants to shift the burden of persuasion in claims subject to entire fairness if a well-functioning committee of independent directors approved the transaction. Just last year, in *Kahn v. M & F Worldwide Corp.*,[63] this Court incentivized controlling stockholders in self-interested transactions to use independent special committees combined with other procedural protections to avoid an entire fairness review of their transactions altogether.

The trial court's rule, however, serves only to undercut the willingness of capable, outside directors to serve on boards that might have a controlling stockholder.[64] As applied here, the *per se* rule cautions independent directors to first ask whether a plaintiff could plead facts showing it is reasonably conceivable that a person or entity across the negotiating table is a controlling stockholder. If

61 457 A.2d 701, 709 n.7 (Del. 1983).

62 638 A.2d 1110, 1117 (Del. 1994).

63 88 A.3d 635, 644 (2014).

64 The Court of Chancery recognized this problem in *Cornerstone*, explaining that "doctrinally it seems insufficient to simply plead that that [sic] a director has participated in a transaction with a controller and thus an inference of disloyalty arises sufficient to sustain a complaint against her." *Cornerstone*, 2014 WL 4418169, at *10.

the answer is "yes," than any facts suggesting that a resulting deal with that stockholder might not be entirely fair would be sufficient to subject the independent directors to the burdens of discovery and trial.[65] They incur these burdens even if each director's loyalty to the corporation is "above reproach."[66]

The trial court's rule imposes costs on directors who act with care and complete loyalty, and who are without any interest in a transaction. These directors enjoy no benefit from a transaction that may be entirely fair, and even if there is no reasonably conceivable claim that they have liability to the corporation or its stockholders, they are subject to the burdens of discovery and trial.[67] Counterintuitively, the trial court's rule creates an incentive to seek an interest in a transaction.[68]

Finally, even assuming empirical support for the assumption that the "possibility of divided director loyalties" is greater in controlling stockholder transactions, the trial court's *per se* rule precludes it from considering important

65 *See, e.g.*, *In re Crimson Exploration Inc. S'holder Litig.*, 2014 WL 5449419, at *10 (Del. Ch. Oct. 24, 2014) (determining whether a non-majority stockholder has control is factually intensive).

66 *See Lewis v. Fuqua*, 502 A.2d 962, 967 (Del. Ch. 1985).

67 *In re Lukens Inc. S'holder Litig.*, 757 A.2d 720, 734 (Del. Ch. 1999) (finding that where a complaint failed to allege only a breach of the duty of care, the director defendants "were entitled to [a] dismissal at this stage of the process, without having to engage in discovery or shoulder the burden of proving that they acted loyally and in good faith"), *aff'd*, 757 A.2d 1278 (Del. 2000) (TABLE).

68 *Cf. In re Synthes, Inc. S'holder Litig.*, 50 A.3d 1022, 1035–36 (Del. Ch. 2012) ("If, however, controlling stockholders are subject to entire fairness review when they share the premium ratably with everyone else, they might as well seek to obtain a differential premium for themselves or just to sell their control bloc, and leave the minority stuck-in.").

case-specific facts. In *Kahn v. Lynch*, for example, the Court considered a self-transaction by a 43% stockholder with five of the eleven members of the company's board of directors, including two of the three members of the executive committee and two of the four members of the compensation committee.[69]

The allegations in the Complaint here are strikingly different. To begin with, Zhu owned only 17.3% of the Company's stock and controlled, at most, 26%.[70] Plaintiffs made no allegation that Zhu (a) had any input regarding the composition of the Special Committee, (b) had any input regarding the nomination or compensation of the Special Committee Directors, either as directors or as members of the Special Committee, or (c) otherwise dominated the Special Committee Directors. To the contrary, the Complaint alleged that the Special Committee Directors constituted the entirety of the Company's nomination and compensation committees.[71] The trial court's finding that Zhu was a controller based not on his control over the Board, but on his influence over stockholder approvals and day-to-day operations, further reinforces the absence of allegations regarding Zhu's dominance over the Board or the Special Committee.[72]

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[69] 638 A.2d at 1112–13.

[70] Op. 2.

[71] *See* A18–19 ¶¶ 12–16.

[72] Op. 20–21.

The *per se* rule applied by the trial court also undercuts this Court's repeated admonition that stockholders use the "'tools at hand' to develop the necessary facts" to support a claim.[73] In fact, in *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*,[74] this Court did so where a plaintiff was required to challenge the independence of outside directors in a case with a 94% controlling stockholder. In even those circumstances, the Court was unwilling to allow a plaintiff to bypass pleading rules without "even attempt[ing] to use the fact-gathering tools available."[75] Here, Plaintiffs had fifteen months to use various fact-gathering tools to ascertain if there was a factual basis to support at least a reasonably conceivable claim that the Special Committee Directors engaged in conduct that would support a damages claim against them. They did not, and have no such claim.

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[73] *See, e.g.*, *Brehm v. Eisner*, 746 A.2d 244, 266 (Del. 2000) (citations omitted); *see also Cohen v. El Paso Corp.*, 2004 WL 2340046, at *2 (Del. Ch. Oct. 18, 2004) ("Both the Court of Chancery and the Delaware Supreme Court have repeatedly admonished shareholder plaintiffs to seek books and records before filing class or derivative complaints, so that they may prepare a factually accurate and legally sufficient pleading." (citation omitted)).

[74] 845 A.2d 1040, 1054, 1056 (Del. 2004).

[75] *Id.* at 1057.

CONCLUSION

The trial court's rule contravenes several fundamental strands of Delaware's corporate law, including the presumption that Delaware directors act in good faith, and the incentives for using independent special committees. Nor was its rule required by this Court's decisions in *Emerald Partners*. Appellants respectfully request that the Court reverse the trial court's decision and remand for a determination of whether plaintiffs sufficiently alleged a non-exculpated claim against the Special Committee Directors.

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CERTIFICATE OF SERVICE

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