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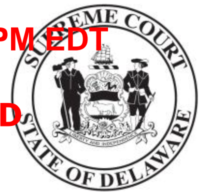

IN THE SUPREME COURT OF THE STATE OF DELAWARE

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

APPELLEES' CORRECTED ANSWERING BRIEF

Dated: April 13, 2015

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NATURE OF THE PROCEEDINGS

On March 27, 2012, Xianfu Zhu ("Zhu"), the controlling stockholder of Zhongpin Inc. ("Zhongpin" or the "Company"), a Delaware corporation listed on the NASDAQ Global Select Market whose assets and operations were located exclusively in the People's Republic of China ("PRC"), proposed to squeeze-out the Company's unaffiliated stockholders at the price of $13.50 per share in cash. Shortly after Zhu made his proposal, Zhongpin's Board of Directors (the "Board") appointed a special committee (the "SC") consisting of three purportedly independent directors. Two of the three SC members, and four of the five Board members, including Zhu, were PRC nationals.

Over the course of the next nearly eleven months, the SC failed to obtain any substantive benefits for the Company's unaffiliated stockholders: Zhu never increased his initial price offer; the SC never made a counter-offer; and it even permitted Zhu to chase away an interested third party offering the unaffiliated stockholders $15.00 per Zhongpin share in cash. In fact, the SC allowed Zhu to pressure it into recommending a transaction at $13.50 per share (the "Merger"), even though its financial advisor advised it could not issue a fairness opinion at a theoretical higher price of *$13.75 per share* and then resigned. The agreement and plan of merger (the "Merger Agreement"), which was the result of a process that did not include a "majority-of-the-minority" voting requirement ab initio,

subsequently was approved by a bare minimum of approximately 51.3% of the Company's common stock held by its unaffiliated stockholders.

The operative Verified Amended Consolidated Complaint (filed Sept. 16, 2013) (the "Complaint") alleged breaches of fiduciary duties against both Zhu and the SC members. Plaintiffs specifically alleged that the SC members were "not independent of Zhongpin and Defendant Zhu, and cannot (and did not) act with undivided loyalty to Zhongpin's public minority stockholders."

Zhu and the members of the SC filed separate motions to dismiss. The court below denied Zhu's motion, concluding that Plaintiffs raised an inference that Zhu was a controlling stockholder; the Merger was subject to entire fairness review; and Plaintiffs pled facts raising an inference that the Merger was not entirely fair. Zhu did not challenge these findings. The court below also found that in light of the foregoing determinations, the purportedly "disinterested" SC members could not prevail on a motion to dismiss.

The SC members subsequently applied for, and obtained certification from the court below, for an interlocutory appeal. This Court accepted that appeal on January 23, 2014.

SUMMARY OF ARGUMENT

1. Denied. The court below properly found that the SCDs (defined below), who are protected by a Section 102(b)(7) exculpation provision, cannot prevail on a motion to dismiss a complaint challenging a squeeze-out merger where Plaintiffs demonstrated: (i) indicia of domination sufficient to raise an inference of the existence of a controlling stockholder; (ii) entire fairness as the mandatory standard of review; and (iii) the Merger was not entirely fair to the Company's unaffiliated stockholders, especially when Plaintiffs alleged (x) reasonably conceivable non-exculpated breaches of the duty of loyalty by the SCDs concerning price fairness, and (y) with specificity that the SCDs lacked independence.

Giving the SCDs an opportunity to avoid liability at the pleading stage under such circumstances is contrary to established law and will allow purportedly independent directors whose true loyalties cannot be determined until after the completion of discovery, at the earliest, to avoid the consequences of failing to protect the interests of the Company's unaffiliated stockholders based upon an undeveloped record.

This Court should therefore affirm the Opinion below.

STATEMENT OF FACTS

On March 27, 2012, Zhongpin announced that its Board[1] had received a preliminary, non-binding proposal from Zhu, Zhongpin's Chief Executive Officer ("CEO"), Chairman, and its largest stockholder,[2] stating that he intended to acquire all of the outstanding shares of the Company's common stock not currently owned by him in a controlling stockholder squeeze-out at a proposed price of $13.50 per share in cash. The Company disclosed that the Board intended to form a special committee of purportedly independent directors to consider Zhu's proposal "and any additional proposal that may be made *by Mr. Zhu and his affiliates*, if any." Form 8-K, Ex. 99.1 (filed Mar. 27, 2012), Transmittal Affidavit of Matthew R. Clark in Support of the Opening Brief of Defendants Raymond Leal, Yaoguo Pan and Xiaosong Hu in Support of their Motion to Dismiss Plaintiffs' Verified Amended Consolidated Complaint, filed December 23, 2013 ("Clark Aff."), at A88 (emphasis added).[3] In his proposal, Zhu stated that he was interested "only in acquiring the common stock of the Company," and that he did not "intend to sell

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[1] The Board consisted of Zhu, Baoke Ben ("Ben"), Raymond Leal ("Leal"), Yaoguo Pan ("Pan"), and Xiaosong Hu ("Hu") (the "Individual Defendants").

[2] Zhu beneficially owned approximately 17.5% of Zhongpin's common stock at the time. Complaint, Appellants' Appendix A15 *et seq.*, ¶ 23 (henceforth, citations to "¶" refer to corresponding paragraphs in the Complaint). This figure remained virtually unchanged until the closing of the Merger. ¶¶ 12, 66.

[3] Whether consciously or not, the Company was tipping its hand from the outset that it would not entertain a proposal from a third party unaffiliated with Zhu. As discussed below, this turned out to be true.

[his] stake in the Company to a third party." ¶ 24; Form 8-K, Ex. 99.1 (filed Mar. 27, 2012), Clark Aff. at A91.

On April 13, 2012, the Company announced the formation of the SC comprised of Leal, Hu, and Pan (collectively, "Appellants" or the "SCDs") and that the SC intended to hire an independent financial advisor "to assist it in its evaluation of the Zhu Proposal and any additional proposal that may be made by Mr. Zhu and his affiliates, if any." ¶ 3; Form 8-K (filed Apr. 13, 2012), Ex. 99.1, Clark Aff. at A97 (emphasis added).[4] The Board delegated to the SC:

> full power and authority . . . in connection with its evaluation of the proposal from the Chairman, including full power and authority to: (a) review, evaluate and negotiate the terms of the proposal from the Chairman or any alternative transaction, including negotiating the definitive agreement or agreements; (b) advise the board of directors whether the proposal from the Chairman or any alternative transaction was advisable and fair to, and in the best interests of, the Company and its unaffiliated stockholders; and (c) reject or approve the proposal from the Chairman or any alternative transaction, or recommend rejection or approval of the proposal from the Chairman or any alternative transaction to the board of directors.

¶ 26; Form DEFM14A (filed May 28, 2013), Clark Aff., at A148 (the "Proxy").

As stated in the Company's Form 10-K (filed Mar. 18, 2013):

> Our largest shareholder has significant influence over our management and affairs and could exercise this influence against your best interests.
>
> At March 11, 2013, Mr. Xianfu Zhu, our founder, Chairman and Chief Executive Officer and our largest shareholder, beneficially owned

[4] *See* n.3, *supra*.

> approximately 17.3% of our outstanding shares of common stock, and our other executive officers and directors collectively beneficially owned an additional 4.2% of our outstanding shares of common stock. As a result, pursuant to our By-laws and applicable laws and regulations, our controlling shareholder [Zhu] and our other executive officers and directors are able to exercise significant influence over our company, including, but not limited to, any shareholder approvals for the election of our directors and, indirectly, the selection of our senior management, the amount of dividend payments, if any, our annual budget, increases or decreases in our share capital, new securities issuance, mergers and acquisitions and any amendments to our By-laws. Furthermore, this concentration of ownership may delay or prevent a change of control or discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of us, which could decrease the market price of our shares.

¶ 67; B 26.

Zhu also maintained control over the day-to-day operations of the Company and had managerial supremacy. The Form 10-K stated:

> We are highly dependent on our senior management to manage our business and operations. . . . In particular, we rely substantially on our founder, Chairman and Chief Executive Officer, Mr. Xianfu Zhu, and our Executive Vice President, Mr. Baoke Ben, to manage our operations. . . . The loss of any one of [our key personnel], in particular Mr. Zhu or Mr. Ben, would have a material adverse effect on our business and operations.

¶ 68; B 22.[5]

On September 28, 2012, the SC concluded that a market check should be

[5] On Zhu's motion to dismiss, the Court of Chancery found that "Plaintiffs plead indicia of domination, sufficient to raise an inference that Zhu exercised control over Zhongpin." *In re Zhongpin Inc. S'holders Litig.*, Consol. C.A. No. 7393-VCN, slip op. at 21 (Del. Ch. Nov. 26, 2014) ("Op."), Appellants' Corrected Opening Brief ("Appellants' Op. Br."), Exhibit A.

conducted. ¶ 30; Proxy at A150. On October 11, 2012, the SC asked Zhu whether he would consider selling his shares to a third party bidder, and he replied that he was unwilling to do so. ¶ 31; Proxy at A151.

On October 16, 2012, Company management provided the SC's financial advisor, Barclays Bank PLC ("Barclays"), with a revised set of management projections ("October Management Projections"), reviewed by Zhu, based upon the Company's preliminary third quarter financial reports. The October Management Projections reflected reductions in Zhongpin's revenue and profits as compared to a set of projections covering 2012 through to 2016, which had been prepared by Zhongpin management in May 2012. ¶ 33; Proxy at A151.

On September 12, 2012, Zhu's initial draft of the Merger Agreement was presented to Barclays. ¶ 29; Proxy at A149. The draft did not contain a "majority-of-the-minority" voting provision. The SC's revised draft of October 16, 2012, "added" such a non-waivable requirement. Proxy at A151. Zhu's representatives replied with a revised draft on October 22, 2012, rejecting, among other things, the majority-of-the-minority voting requirement. *Id.* at A152. Zhu's representatives again rejected the majority-of-the-minority voting requirement on November 2, 2012. *Id.* at A153. On November 6, 2012, Zhu's representatives informed the SC's representatives that Zhu would accept, among other things, a non-waivable majority-of-the-minority voting requirement "subject to the special committee

accepting the offer price of $13.50 per share." *Id.* at A154.

The court below found that controlling stockholder Zhu's failure to condition the Merger ab initio on an uncoerced, informed vote of the majority of the minority stockholders did not satisfy the bright line test for business judgment review enunciated in *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635 (Del. 2014). Op at 24. Consequently, the Merger was subject to entire fairness review. *Id.*

On October 19, 2012, Barclays initiated a market check process. ¶ 34; Proxy at A152. On November 15, 2012, Barclays received a non-binding proposal from a potential strategic acquirer ("Bidder A") to acquire all of the Company's stock not owned by Zhu for $15.00 per share, *$1.50 per share more than offered by Zhu*, subject to Zhu participating as a rollover stockholder and continuing as Chairman and CEO of the Company after the acquisition. ¶ 42; Proxy at A155. On November 17, 2012, Zhu stated he was not interested in continuing as CEO of the Company if the majority ownership in the Company was sold to Bidder A and that, in his capacity as a stockholder of the Company, he was unwilling to roll over his equity ownership in the Company in connection with Bidder A's proposal. ¶ 44; Proxy at A155.

The SC requested on November 2, 8, and 18, 2012, that Zhu raise his offer price. ¶¶ 38, 46; Proxy at A153-54, A156. However, it did not make a specific counter-offer or even state what it considered to be a fair price. *Id.* For his part,

Zhu reiterated on November 7, 15, and 17, 2012, that he would not increase his price or sell his shares. ¶¶ 40, 45; Proxy at A154-55.

The SCDs could have turned up the pressure on Zhu at that point by telling him, for example, there would be no further discussions unless he at least matched Bidder A's offer. Not only did they fail to bargain hard with Zhu, they bent to the pressure Zhu turned up on them. Zhu delivered a letter to the SC on November 17, 2012, stating he had secured sufficient debt and equity financing from the China Development Bank ("CDB") and another entity. The letter also informed the SC that Zhu would seriously consider withdrawing his proposal unless the SC indicated to him by midnight on November 21, 2012, that it intended to approve and recommend the Merger Agreement and proposed Merger to the Board. ¶ 45; Proxy at A155-56. On November 21, 2012, applying further pressure, Zhu informed the SC that the CDB could withdraw its financing commitment if there continued to be delays in signing the Merger Agreement, and that in such event, Zhu would not have the financing necessary to consummate the Merger and would likely be left with no choice but to withdraw his proposal. ¶ 49; Proxy at A156.

On November 22, 2012, the SC began to cave in to Zhu's pressure. The SC's counsel explained that according to Zhu's counsel:

> the debt financing could be protected if the special committee agreed to conclude and enter into the merger agreement with [Zhu] quickly, [Zhu] would agree then to the inclusion of an additional right in the merger agreement to terminate the merger agreement in the sole

> discretion of the Company, acting at the direction of the special committee on or prior to January 25, 2013 without adverse consequence for any party, including no termination fee payable by either the Company or the Chairman.

Proxy at A157.

Even though Barclays had informed the SC on November 18, 2012, that it was not prepared to render an opinion on the fairness of the consideration offered by Zhu, ¶ 46; Proxy at A156, the SC asked Barclays on November 22, 2012, if it was prepared to deliver a fairness opinion. Proxy at A157. Barclays, which was under the misimpression that Zhu was willing to increase his offer by $0.25 to $13.75 per share, responded later that day that it was still not in a position to render a fairness opinion, even at a theoretical offer price of $13.75 per share. ¶ 50; Proxy at A157.

Zhu did not raise his offer. On November 23, 2012, Barclays terminated its engagement with the SC, and advised that "no written or oral advice, analyses, presentations, summaries or findings previously provided by Barclays to the special committee shall be relied upon in connection with any evaluation or decisions to be made by any of the special committee, the board of directors or the stockholders of the Company." ¶ 52; Proxy at A157. Nevertheless, later that day, without a fairness opinion supporting Zhu's $13.50 per share bid, the SC bowed to Zhu's pressure and unanimously determined that the Merger Agreement was advisable and fair to, and in the best interests of, the Company and its

unaffiliated stockholders, and recommended that the Board adopt a resolution approving the same. ¶ 53; Proxy at A157-58.[6] The full Board immediately followed the SC's recommendation, and unanimously approved the Merger Agreement and its related transaction agreements, which were executed on November 26, 2012. ¶ 54; Proxy at A158. The signing of the Merger Agreement was publicly announced that day. ¶ 54; Form 8-K (filed Nov. 26, 2012), *see* B 152.

The inclusion of a termination-fee-free post-Merger Agreement "go-shop" period was an exercise in futility, given Zhu's unyielding unwillingness to do anything other than acquire all of the Company's outstanding shares at $13.50 per share. The agreed-upon 60-day "go-shop" period commenced immediately, without a financial advisor to lead the process. ¶ 55; Proxy at A159. On December 10, 2012, more than two weeks into the "go shop" period, the SC engaged Cowen and Company (Asia) Ltd. and Duff & Phelps, LLC (jointly, the "Replacement Financial Advisors") as joint financial advisors to manage the go-shop process, negotiate with any potential strategic or financial bidders who might emerge during the "go-shop" process, and deliver fairness opinions. ¶ 56; Proxy at A159.

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[6] In so doing, the SC specifically considered "the information contained in the preliminary valuation analysis provided by Barclays on November 2, 2012" despite Barclay's warning not to rely on any of its work. Proxy at A158.

The Replacement Financial Advisors did not initiate the go-shop process until December 24, 2012, almost a month into the 60-day "go-shop" period and immediately preceding the holidays, when they contacted potential financial and strategic investors. *Id.* On January 12, 2013, Bidder A indicated to the Replacement Financial Advisors it was not interested in pursuing any transaction that was not supported by the Company's management team, including Zhu, and that it might not be interested in a transaction involving Zhongpin even if Zhu agreed to partner with Bidder A. ¶ 57; Proxy at A159. Zhu reconfirmed on February 7, 2013, that he was unwilling to work with Bidder A or anyone else. ¶ 62; Proxy at A160.[7]

Of the 55 private equity firms and 28 strategic investors contacted by the Replacement Financial Advisors during the "go-shop" period, *not one* submitted a proposal or even executed a confidentiality agreement. ¶ 60; Proxy at 159. On February 1, 2013, after being asked by the Replacement Financial Advisors, Zhu said once again he was not willing to increase his price. ¶¶ 59, 61; Proxy at A160.

[7] On January 14, 2013, the Merger Agreement was amended to extend the 60-day go-shop period until February 8, 2013, and to extend the date on which the Merger Agreement could be terminated by the Company at the direction of the SC for any reason until February 8, 2013. ¶ 58; Proxy at A159. Neither provision proved necessary.

On February 8, 2013, after receiving fairness opinions from the Replacement Financial Advisors,[8] the SC voted unanimously to approve the terms of the amended and restated Merger Agreement and the transactions contemplated therein.[9] The full Board subsequently followed suit, unanimously approved the terms of the amended and restated Merger Agreement and the transactions contemplated thereby, and recommended that Zhongpin's stockholders vote to adopt the Merger Agreement. ¶¶ 63-64; Proxy at A161. The amended and restated Merger Agreement was executed on February 8, 2013. Proxy at A161.

The Zhongpin stockholder vote took place on June 27, 2013. Only approximately 51.3% of the Company's common stock held by unaffiliated stockholders was voted in favor of the Merger Agreement. ¶ 7.

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[8] Plaintiffs specifically alleged the Merger consideration was unfair, and pled that the analyses done by the Replacement Financial Advisors showed that Zhongpin's value was at least equal to the price offered by Bidder A and probably considerably higher. ¶¶ 81-87.

[9] The amended and restated Merger Agreement (i) removed the go-shop provision from the Merger Agreement; (ii) removed the right of the Company to terminate the Merger Agreement at any time for any reason without payment of termination fees; and (iii) changed the amount of the termination fee payable by the Company from $5,000,000 to $4,750,000. ¶ 64; Proxy at A160.

ARGUMENT

Question Presented

Where the Court of Chancery has properly determined on a motion to dismiss that the complaint challenging a squeeze-out merger adequately demonstrates: (i) indicia of domination sufficient to raise an inference of the existence of a controlling stockholder; (ii) entire fairness is the standard of review; and (iii) that the merger was not entirely fair to the company's unaffiliated stockholders, did the Court of Chancery correctly reject the contention by members of a special committee that their exculpation defense to plaintiffs' breach of duty of loyalty allegations could not require dismissal at the pleading stage?

Scope of Review

This Court reviews "de novo the [Court of Chancery's] decision to grant a motion to dismiss under Rule 12(b)(6)." *Allen v. Encore Energy Partners, L.P.*, 72 A.3d 93, 100 (Del. 2013) (internal citations omitted).

Merits of Argument

In addressing a motion to dismiss pursuant to Rule 12(b)(6), this Court must:

> Accept all well-pleaded factual allegations in the Complaint as true, accept even vague allegations in the Complaint as "well-pleaded" if they provide the defendant notice of the claim, draw all reasonable inferences in favor of the plaintiff, and deny the motion unless the plaintiff could not recover under any reasonably conceivable set of circumstances susceptible of proof.

Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Holdings LLC, 27 A.3d 531,

536 (Del. 2011). The reasonable conceivability "standard asks whether there is a possibility of recovery." *Quadrant Structured Prods. Co. v. Vertin*, 102 A.3d 155, 171 (Del. Ch. 2014) (quotations omitted).

I. THE COURT PROPERLY DENIED THE SCDS' MOTION TO DISMISS BECAUSE PLAINTIFFS MET THE APPLICABLE PLEADING STANDARD TO STATE BREACH OF FIDUCIARY DUTY CLAIMS IN A CONTROLLING STOCKHOLDER BUYOUT TRANSACTION

The present interlocutory appeal bears a number of factual and procedural similarities to the one currently pending in *In re Cornerstone Therapeutics Inc. Stockholder Litigation*, No. 564, 2014 (Del.). In that case, appellees argue that the court below properly denied the Director Defendants' motion to dismiss because the Section 102(b)(7) provision did not warrant their dismissal from the action. *See Cornerstone*, Appellees' Answering Brief, Filing ID 56509828, at 19-28 (Dec. 23, 2014).[10]

That argument applies with equal force here. Both cases involve controlling stockholder squeeze-outs in which the initial offer was not predicated on a majority-of-the-minority vote, the controlling stockholder stated clearly and unambiguously he was only interested in acquiring the shares he did not already own and would not consider selling his shares or entertain another strategic transaction, entire fairness was the appropriate standard of review, and plaintiffs alleged facts supporting an inference that the merger was not entirely fair to the company's unaffiliated or minority stockholders. Op. at 21, 24, 26; *In re Cornerstone Therapeutics Inc. S'holder Litig.*, 2014 Del. Ch. LEXIS 170, *5, 7,

[10] Rigrodsky & Long, P.A. and Levi & Korsinsky LLP are Co-Lead Counsel, with others, for Plaintiffs-Appellees in both *Cornerstone* and the present action.

14-15 (Del. Ch. Sept. 10, 2014). In *Cornerstone*, the court below determined:

> I find, consistent with *Emerald Partners II* [*Emerald Partners v. Berlin*, 787 A.2d 85, 97 (Del. 2001)], that the Plaintiffs have made a sufficient pleading that a stockholder controlled the corporate machinery; that it used that machinery to facilitate a transaction of which it thus stood on both sides; that the transaction was not entirely fair to the minority; and that the Director Defendants negotiated or facilitated the unfair transaction. *Such a pleading is sufficient, under controlling precedent, to withstand a motion to dismiss on behalf of the Director Defendants*. Once the question of entire fairness is resolved after trial, and if I find the transaction not entirely fair, then the issue of whether the Director Defendants breached a non-exculpated duty may be addressed.

2014 Del. Ch. LEXIS 170, *41-42 (emphasis added). In the present action, the court below found:

> Plaintiffs have sufficiently pled Zhu's status as a controlling stockholder, subjecting the Merger to entire fairness review. They have also pled facts supporting an inference that the Merger was not entirely fair to Zhongpin's unaffiliated stockholders. Therefore, the disinterested Special Committee Directors, who were protected by a § 102(b)(7) provision, cannot prevail on a motion to dismiss, despite Plaintiffs' failure to plead a non-exculpated claim for breach of fiduciary duty against them with particularity.[57]
>
> [57] Because of its irrelevance to this analysis, the Court does not consider whether the Plaintiffs have sufficiently pled facts raising an inference that the Special Committee Directors were not independent.

Op. at 28 & n.57 (footnote omitted).[11]

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[11] The standard that special committee directors cannot prevail on a motion to dismiss based upon an exculpation defense in a controlling stockholder takeover that is subject to entire fairness review where the plaintiff has alleged facts supporting an inference that the merger was not entirely fair is referred to herein as the "per se rule."

The appellees in *Cornerstone* argued that in an action where entire fairness applies and there are indicia of unfairness, it would be premature, prior to any discovery, to determine on a motion to dismiss whether a company's Section 102(b)(7) provision exculpates special committee members from liability, and that doing so would be contrary to well-established law. Plaintiffs adopt, but will not repeat, those arguments on this appeal.

II. THE FACTS OF THE PRESENT ACTION DEMONSTRATE WHY ABANDONING THE PER SE RULE WOULD BE ESPECIALLY UNFAIR TO ZHONGPIN'S UNAFFILIATED STOCKHOLDERS

Although this case is similar to *Cornerstone,* the conduct of Zhu and the SCDs calls into question their loyalty and good faith more forcefully than in *Cornerstone* in the following respects:

- Zhu repeatedly refused to, and never did, raise his initial $13.50 per share offer price;
- The SC never made a counter-offer to Zhu's $13.50 price, even when it received an offer at $15.00 per share from Bidder A;
- Zhu pressured the SC to recommend approval of the Merger Agreement under threat that he could withdraw his proposal;
- The SC initially recommended approval of the Merger Agreement on November 23, 2012, the day Barclays resigned because it was unwilling to render a fairness opinion at *$13.75* per share, $0.25 *higher* than the price the SC subsequently agreed to;
- Zhu conditioned his acceptance of a majority-of-the-minority voting provision on the SC's acceptance of his opening and final price of $13.50 per share;
- The SC members' compensation was both material to them and excessive;
- Only a bare majority (approximately 51.3%) of Zhongpin's shares of common stock held by unaffiliated stockholders were voted in favor of the Merger Agreement; and
- Plaintiffs alleged with particularity that the SCDs were not independent of Zhu and did not act with undivided loyalty to Zhongpin's unaffiliated stockholders.[12]

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[12] As noted above, the Court of Chancery did not consider whether Plaintiffs sufficiently pled facts raising an inference that the SCDs were not independent.

These facts, along with the others alleged by Plaintiffs, demonstrate the SCDs were an integral part of a successful controlling stockholder squeeze-out subject to entire fairness review with indicia of unfairness. As noted by the court below, "one can infer that Zhu's dominance over Zhongpin left the Company with no practical alternatives other than to accept his Proposal," Op. at 20 n.31, making the SCDs crucial in protecting the interests of the Company's unaffiliated stockholders. Nevertheless, the SCDs argue that Plaintiffs should be required to oppose a Rule 12(b)(6) motion to dismiss premised upon a presumption of their good faith, thereby placing the initial burden of persuasion of a non-exculpated breach of fiduciary duty on Plaintiffs. Appellants' Op. Brief at 14-15.

The SCDs' argument is both contrary to law and far too surgical and compartmentalized given their active and crucial role in the events leading to the Merger Agreement. "[T]he shield from liability provided by a certificate of incorporation provision adopted pursuant to 8 Del. C. § 102(b)(7) is in the nature of an affirmative defense. Defendants seeking exculpation under such a provision will normally bear the burden of establishing each of its elements." *Emerald Partners v. Berlin*, 726 A.2d 1215, 1223-24 (Del. 1999) ("*Emerald Partners I*"). A presumption of good faith would be especially inequitable to Zhongpin's

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Op. at 28 n.57. While the sufficiency of those allegations are not at issue in this interlocutory appeal, Plaintiffs plainly alleged sufficient facts to raise an inference as to the SCDs' lack of independence.

unaffiliated stockholders in light of the indicia of the lack of independence[13] and good faith on the part of the SCDs pled by Plaintiffs, their failure to engage in *any* bargaining with Zhu over price, and their accelerated initial approval of the Merger Agreement in order to meet Zhu's demands immediately after their financial advisor had informed them that it could not opine that even $13.75 per share would be fair to the stockholders.

"In controller transactions, the 'effective functioning of the Special Committee as an informed and aggressive negotiating force is of obvious importance to the public stockholders.'" *In re Orchard Enters., Inc. S'holder Litig*., 88 A.3d 1, 21 (Del. Ch. 2014) (quoting *Clements v. Rogers*, 790 A.2d 1222, 1242 (Del. Ch. 2001)). As such, a special committee member who acts "on extraneous considerations or influences, such as where one director effectively

[13] "'Independence' does not involve a question of whether the challenged director derives a benefit *from the transaction* that is not generally shared with the other shareholders. Rather, it involves an inquiry into whether the director's decision resulted from that director being *controlled* by another. A director can be controlled by another if in fact he is *dominated* by that other party, whether through close personal or familial relationship or through force of will. A director can also be controlled by another if the challenged director is *beholden* to the allegedly controlling entity. A director may be considered beholden to (and thus controlled by) another when the allegedly controlling entity has the unilateral power (whether direct or indirect through control over other decision makers), to decide whether the challenged director continues to receive a benefit, financial or otherwise, upon which the challenged director is so dependent or is of such subjective material importance to him that the threatened loss of that benefit might create a reason to question whether the controlled director is able to consider the corporate merits of the challenged transaction objectively." *Orman v. Cullman*, 794 A.2d 5, 25 n.50 (Del. Ch. 2002) (emphases in original).

controls another," rather than on the corporate merits of the subject, lacks independence and breaches his duty of loyalty if the lack of independence is material. *In re Alloy, Inc. S'holder Litig.*, 2011 Del. Ch. LEXIS 159, *24 (Del. Ch. Oct. 13, 2011) (partial quotation omitted). *See also Frank v. Elgamal*, 2014 Del. Ch. LEXIS 37, at *71 (Del. Ch. Mar. 10, 2014) ("a director may lack independence if he is 'beholden' to an extraneous influence, like a controlling stockholder, such that his business discretion 'would be sterilized'") (quoting *Rales v. Blasband*, 634 A.2d 927, 936 (Del. 1993)).

This Court has said that "deciding whether an independent committee was effective in negotiating a price is a process so fact-intensive and inextricably intertwined with the merits of an entire fairness review (fair dealing and fair price) that *a pretrial determination of burden shifting is often impossible*." *M&F Worldwide*, 88 A.3d at 646 (emphasis added). But here, the SCDs are seeking far more at the pleading stage with respect to exculpation – they desire dismissal, not a mere burden shift, notwithstanding their intimate involvement in the Merger, the indicia of unfairness, and Plaintiffs' pleading of a lack of independence on their part. Given the applicability of the entire fairness standard, the burden of keeping them in the case at the pleading stage does not properly fall to Plaintiffs, because the SCDs bear the burden of establishing an exculpation defense. *Emerald Partners I*, 726 A.2d at 1223-24.

In the controller-led going private context, this Court has held that a "complaint would state a claim for relief that would entitle the plaintiff to proceed and conduct discovery" if a plaintiff can plead a "reasonably conceivable set of facts" showing that *any* of the following six factors *did not exist*:

> (i) the controller conditions the procession of the transaction [from the outset] on the approval of both a Special Committee *and* a majority of the minority stockholders; (ii) *the Special Committee is independent*; (iii) the Special Committee is empowered to freely select its own advisors and to say no definitively; (iv) the Special Committee meets its duty of care *in negotiating a fair price*; (v) the vote of the minority is informed; and (vi) there is no coercion of the minority.

M&F Worldwide, 88 A.3d at 645 (emphases added). The Court also noted that "allegations about the sufficiency of the price call into question the adequacy of the Special Committee's negotiations, *thereby necessitating discovery on all of the new prerequisites to the application of the business judgment rule*." *Id*. at 645 n.14 (emphasis added). Further, once entire fairness is established as the standard of review, it is applied to purportedly independent special committee directors "in order to ensure that all parties to the transaction have fulfilled their fiduciary duties to the corporation and all its shareholders." *Kahn v. Tremont Corp*., 694 A.2d 422, 429 (Del. 1997) (citation omitted).

The court below properly determined that Zhu's proposal did not include a majority-of-the-minority provision from the outset, and thus entire fairness was the

appropriate standard of review. Op. at 24.[14] Consequently, the Court declined to consider as unnecessary Plaintiffs' allegations about the sufficiency of price as a factor to determine whether the Merger was subject to entire fairness review. *Id*. at 23 n.40.[15]

However, Plaintiffs' allegations regarding the sufficiency of price stated persuasive (and thus reasonably conceivable) non-exculpated breaches of the duty of loyalty by the SCDs. The court below specifically determined that "Plaintiffs' allegations of unfair dealing and price sufficiently meet the 'reasonably conceivable' standard of a motion to dismiss." *Id*. at 26.

As the Court of Chancery stated recently:

> Under controlling Delaware Supreme Court precedent, entire fairness governs interested transactions between a corporation and its controller, *even if a special committee of independent directors* or a majority-of-the-minority vote *is used, because of the risk that when push comes to shove, directors who appear to be independent and disinterested will favor or defer to the interests and desires of the majority stockholder*.

[14] The rationale for requiring a majority-of-the-minority provision *from the outset* in order to obtain business judgment review is to prevent "the controlling stockholder [from] dangl[ing] a majority-of-the-minority vote before the special committee late in the process as a deal-closer rather than having to make a price move." *M&F Worldwide*, 88 A.3d at 644. *That is precisely what Zhu did in this case*. *See* Proxy at A154 ("On November 6, 2012, [Zhu's counsel] sent to [the SC's counsel] a further revised draft of the merger agreement and informed [the SC's counsel] by phone that [Zhu] was willing to accept the non-waivable majority of the minority voting requirement . . . *subject to the special committee accepting the offer price of $13.50 per share*.") (emphasis added).

[15] Plaintiffs' allegations as to the unfairness of the Merger consideration were set forth in ¶¶ 81-87 of the Complaint. Op. at 23 n.40.

Quadrant, 102 A.3d at 194 (citing *Kahn v. Lynch Commc'n Sys. Inc.*, 638 A.2d 1110, 1116-17 (Del. 1994) (emphasis added)). "Particularly in controlling stockholder transactions, there is the risk 'that the outside directors might be more independent in appearance than in substance.'" *Id*. (quoting *In re Cox Commc'ns, Inc. S'holders Litig.*, 879 A.2d 604, 619 (Del. Ch. 2005)). Furthermore, as the Court of Chancery succinctly stated:

> The entire fairness test helps uncover situations where facially independent and disinterested directors have failed to act loyally and in good faith to protect the interests of the corporation and the stockholders as a whole and instead have given in to or favored the interests of the controller. By independently reviewing the procedural and substantive fairness of the transaction with the burden of proof on the defendant directors, the court can identify those situations and, if necessary, impose a remedy. What this means for purposes of *Section 102(b)(7)* is that when a case involves a controlling stockholder with entire fairness as the standard of review, and when there is evidence of procedural and substantive unfairness, *a court cannot summarily apply Section 102(b)(7) on a motion to dismiss to enter judgment in favor of facially independent and disinterested directors*. *Under those circumstances, it is not possible to hold as a matter of law that the factual basis for [the] claim solely implicates a violation of the duty of care*. Rather, the inherently interested nature of [the transaction becomes] inextricably intertwined with issues of loyalty.

Id. at 194-95 (citations and quotations omitted, emphasis added, brackets in original). *See also Tremont Corp*., 694 A.2d at 428 ("Entire fairness remains applicable even when an independent committee is utilized because the underlying factors which raise the specter of impropriety can never be completely eradicated and still require careful judicial scrutiny. This policy reflects the reality that in a

transaction such as the one considered in this appeal, the controlling shareholder will continue to dominate the company regardless of the outcome of the transaction.") (citations omitted).

In addition to questions as to price fairness, the proceedings below illustrate why the SCDs should not be subject to dismissal at the pleading stage. Plaintiffs alleged, among other things, that SCDs Hu and Pan earned $30,000 apiece annually for serving on Zhongpin's Board and approximately $52,000 apiece for serving on the SC, sums vastly outstripping, in Hu's case, the amount that newly-hired academics earn in the PRC (Hu teaches at the Food Science and Engineering College of the China Agricultural University), and in Pan's case, the average annual income for a Chinese family of four in both urban and rural areas (Pan works as a researcher for a state run institution). ¶¶ 75-76.

"For director compensation to create independence problems . . . it must be shown that the compensation is material to the director." *MCG Capital Corp. v. Maginn*, 2010 Del. Ch. LEXIS 87, at *74 (Del. Ch. May 5, 2010) (citing *Orman v. Cullman*, 794 A.2d at 25 n.50); *see also Orman,* 794 A.2d at 29 n.62 (director fees that "exceed materially what is commonly understood and accepted to be a usual and customary director's fee" may demonstrate a lack of independence). The SCDs argued below that "Plaintiffs' challenge to the independence of the [SCDs] also rests on pure speculation that the directors' fees were meaningful to those

directors in the context of their individual economic circumstances, and should be rejected." Opening Brief of Defendants Raymond Leal, Yaoguo Pan and Xiaosong Hu in Support of Their Motion to Dismiss Plaintiffs' Verified Amended Consolidated Complaint (Dec. 23, 2013), Appellants' Appendix A71.[16]

This is exactly the type of argument the per se rule properly seeks to avoid at the pleading stage. The SCDs, who were an integral part of a transaction the court below found may not have been entirely fair, should not be subject to exculpation so early in the proceedings based on whether their facially more-than-ample compensation was material to them. Instead, equity requires that Plaintiffs be permitted to engage in discovery to determine, among other things, the materiality of the compensation each SCD received for his Board and SC service, at least, as here, where the Complaint adequately pleads facts creating a reasonable inference that such compensation was sufficient to compromise the SCDs' independence from Zhu. This can only be assured if the per se rule is retained.

It bears emphasizing that, even though the court below did not specifically consider the SCDs' independence (or lack thereof) or the sufficiency of Plaintiffs' pleading that they breached their fiduciary duty of loyalty, the court below acknowledged that "Zhu's relationship with Zhongpin and the Board (together

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[16] Moreover, if the Court had considered all six criteria in *M&F Worldwide*, it would have had to determine whether "the Special Committee is independent." 88 A.3d at 645. Plaintiffs alleged it was not and the reasons why its independence was compromised. *See*, *e.g.*, ¶¶ 3, 71-76, 89.

with the allegations suggesting the absence of fairness) *raises the possibility* that the Individual Defendants breached those [non-exculpated] duties." Op. at 28 n.56 (emphasis added). In other words, the per se rule did exactly what it is intended to do – defer a decision on the SCDs' liability, *and the precise nature of that liability*, until after the facts are developed, where Plaintiffs alleged a non-exculpated breach of fiduciary duty on their part.[17] This Court has said "there is no 'safe harbor' for . . . divided loyalties in Delaware." *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983). However, abandoning the per se rule will open a wide berth in a safe harbor for disloyal directors.

If the per se rule does not stand, then unaffiliated or minority stockholders will be put at great risk. "Controller transactions are the corporate transactions where the possibility of divided director loyalties, *often cryptic and unknowable at the pleading stage*, is of greatest concern, as has been explicitly stated by this Court." *Cornerstone*, 2014 Del. Ch. LEXIS 170 at *39 (emphasis added).

There are additional factors in the present action demanding retention of the per se rule. The Court of Chancery has called for the careful application of Delaware law to entities incorporated in Delaware but controlled and operated in foreign countries by a foreign national with less than a majority interest,

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[17] The SCDs' claim that Plaintiffs have attempted to "bootstrap a breach of loyalty claim against a controlling stockholder into a claim against the Special Committee," Appellants' Op. Br. at 18-19, disregards Plaintiffs' specific allegations regarding the SC's lack of independence.

particularly in the PRC, because such entities are not "typical." *In re China Sec. & Surveillance Tech., Inc., S'holders Litig.*, Consol. C.A. No. 6279-CS (Del. Ch. July 10, 2012) (TRANSCRIPT), at 10.[18] Exhibit A.

The court in *China Security* expressed its dissatisfaction with a proposed disclosure-only settlement of breach of fiduciary claims against the former directors of a PRC-based Delaware shell corporation that had been taken private by its largest stockholder, a PRC national. The court was particularly concerned that the three-person special committee, which included two PRC nationals, had been overly supine with respect to the largest stockholder, failing to obtain a price increase or any other significant benefit for the company's common stockholders. *Id*. at 15 (THE COURT: "Aren't you concerned about releasing a claim where a special committee basically got bupkis?").[19] The court below also engaged in the

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[18] As stated in a recent New York Times article: "In a country where the profits have been so tempting, the warning signs — the complex corporate structures, the opaque deals, the political influence — often go unheeded. Investors, *even sophisticated investors*, either miss them or ignore them." David Barboza, *In China, a Building Frenzy's Fault Lines,* N.Y. TIMES, Mar. 13, 2015, http://www.nytimes.com/2015/03/15/business/dealbook/in-china-a-building-frenzys-fault-lines.html?hp&action=click&pgtype=Homepage&module=first-column-region®ion=top-news&WT.nav=top-news (emphasis added). As a result, it is critically important for Delaware courts to apply time-tested stockholder protection principles to such entities.

[19] The facts in *China Security* are very similar to the present action, in that they both involved PRC-based Delaware shell companies; squeeze-outs by the largest stockholder, a PRC national (neither of whom was close to being a majority stockholder); three person special committees consisting of two PRC nationals; failures by the special committees to obtain any significant concessions for the

following discussion with counsel for plaintiffs:

> THE COURT: Reverse. These are people -- was this a public shell?
> MR. LONG: Right.
> THE COURT: Creepy business that we need to end.

Id. at 26.

Need to end it, we must. Doing so will be substantially more difficult unless purportedly independent directors of such companies, *and all Delaware public companies*, are held to the per se rule, rather than giving them an opportunity to avoid liability where their independence has been adequately challenged and before all the facts are known. If the per se rule is not applied, then the SCDs could escape liability despite the presence of strong indicia of their complicity in an unfair transaction involving both an unfair process and unfair price.

In addition, the Court of Chancery has stated with respect to PRC-based Delaware shell corporations that "*the only reason to have independent directors -- remember, you don't pick them for their industry expertise. You pick them because of their independence* and their ability to monitor the people who are managing the company." *In re Puda Coal, Inc. S'holders Litig.*, Consol. C.A. No. 6476-CS (Del. Ch. Feb. 6, 2013) (TRANSCRIPT), at 21 (derivative action on behalf of Chinese

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company's common stockholders from the largest stockholder's initial proposal; pressure from the largest stockholder to recommend the deal quickly in order to obtain financing from the China Development Bank; and recommendations of approval of the proposed transactions by the special committees despite the lack of a fairness opinion from their financial advisors, with substitute financial advisors providing fairness opinions after the fact.

shell company) (emphasis added). Exhibit B. Here, the two PRC nationals on the SC – Hu and Pan – apparently *were* picked for their technical expertise. The court below stated Hu's experience as having "taught and researched at the Food Science and Engineering College of the China Agricultural University" for over two decades and "serv[ing] in an array of academic and governmental organizations, mostly related to agriculture and food science." Op. at 4; *see also* ¶ 75. Pan was described as "a researcher for Chinese government institutions . . . focus[ing] on the meat industry, food nutrition, and rural policy." *Id.*; *see also* ¶ 76. Thus, there is no basis upon which to presume Hu and Pan were selected for their independence. Again, these are not issues that Plaintiffs should have to deal with at the pleading stage, which provides additional reason to retain the per se rule.

Boiled down, the SCDs' position is that they should be presumed to have acted in good faith and independently even though they obtained "bupkis" on behalf of Zhongpin's unaffiliated stockholders, specifically failing to obtain any significant concessions from Zhu, and quickly caving in to Zhu's demands when he turned up the pressure on them.[20] Despite all this – the court below's findings

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[20] The Court of Chancery's analogy likening a controlling stockholder to an "800-pound gorilla whose urgent hunger for the rest of the bananas is likely to frighten less powerful primates like putatively independent directors," *In re Pure Res., Inc., S'holder Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002), quoted in *Quadrant*, 102 A.3d at 194, was prescient, because the facts pled show the purportedly independent SCDs were of no mind to challenge Zhu seriously on any issue of significance to the Company's unaffiliated stockholders.

that Plaintiffs adequately pled Zhu was a controlling stockholder, entire fairness was the standard of review, the merger was not entirely fair to the company's unaffiliated stockholders, and "Zhu's relationship with Zhongpin and the Board (together with the allegations suggesting the absence of fairness) rais[ed] the possibility that the Individual Defendants breached those [non-exculpated] duties," as well as the Court of Chancery's prior observation of the "creepy business" of a foreign shell Delaware company being taken private by a non-majority controlling foreign national stockholder with the approval of a special committee dominated by foreign nationals who offered no resistance to the controlling stockholder – the SCDs claim they should be entitled on a motion to dismiss to what is essentially a conclusive presumption of good faith in the performance of their fiduciary duties. Their argument is illogical, suggests bad public policy, and is unfair to Zhongpin's unaffiliated stockholders.

The per se rule should be retained. It was eminently reasonable for the court below to determine that the SCDs were not subject to exculpation under Section 102(b)(7) at the pleading stage, especially when Plaintiffs pled specific facts questioning price fairness as well as their independence,[21] and thus their loyalty.[22]

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[21] The SCDs cite *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004), for the proposition that directors are entitled to a presumption they were faithful to their fiduciary duties. Op. Br. at 13-14. *Beam* does not support that proposition in the context of stockholder class action alleging breach of fiduciary duties where entire fairness is the standard of review. *iXCore,*

III. THE SCDS' ARGUMENTS REINFORCE THE NEED TO RETAIN THE PER SE RULE

The SCDs quote a passage from the Court of Chancery in *Southern Peru Copper* to the effect that "[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." Op. Brief at 17 (quoting *In re S. 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) (emphasis in original)). They also quote the subsequent sentence from the opinion: "[u]nless there are facts suggesting that the

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S.A.S. v. Triton Imaging, Inc., 2005 Del. Ch. LEXIS 102, at *2 (Del. Ch. July 8, 2005). *Beam* was a derivative action, whereas the present matter is a direct action. "The importance of that distinction is that *plaintiff is not required to plead with particularity why demand should be excused, or more precisely, why a majority of the board was not disinterested and independent such that demand could properly be considered*. Defendants' citation[] to . . . *Beam* . . . [is] not controlling, as the analysis in [that] case[] was dependent on the derivative claims asserted therein, where the pleading standard is higher and particularized facts are required, unlike here." *Id*. (emphasis added).

[22] The Court of Chancery's opinion was inconclusive as to the effectiveness of Plaintiffs' pleading regarding the independence of the SCDs. The body of the opinion stated "the disinterested Special Committee Directors, who were protected by a § 102(b)(7) provision, cannot prevail on a motion to dismiss, despite Plaintiffs' failure to plead a non-exculpated claim for breach of fiduciary duty against them with particularity." Op. at 28. The Court immediately added in a footnote that "[b]ecause of its irrelevance to this analysis, the Court does not consider whether the Plaintiffs have sufficiently pled facts raising an inference that the Special Committee Directors were not independent." *Id*. n.57. As discussed above, the Complaint contained numerous allegations that the SCDs were not independent. *See*, *e.g.*, ¶¶ 3, 71-76, 89.

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." *Id*. (quoting *S. Peru Copper*, 52 A.3d at 787 n.72).

However, the SCDs failed to note that "the independence of the Special Committee was not challenged" in that case. *Ams. Mining Corp.*, 51 A.3d at 1241. Moreover, the *burden of proof* at the pleading stage for the purportedly independent directors was not at issue in *Southern Peru Copper*; rather, the question was whether the Court of Chancery erred by determining the *burden of persuasion following a trial*, a procedural benefit the Court characterized as "modest." *Id*. at 1242.

In contrast, the Court of Chancery determined the Merger must be reviewed for entire fairness and that Plaintiffs raised an inference it was unfair. Ignoring Plaintiffs' allegations regarding their lack of independence, the SCDs claim that *Southern Peru Copper* stands for the proposition that Plaintiffs still must demonstrate an unexculpated claim of breach of fiduciary duty at the pleading stage. It does no such thing. The special committee defendants in *Southern Peru Copper* were dismissed *following a motion for summary judgment*, not at the pleading stage, "because the plaintiff had failed to present evidence supporting a non-exculpated breach of their fiduciary duty of loyalty." 52 A.3d at 785.[23] In

[23] In *Emerald Partners II*, 787 A.2d at 97, this Court said "[t]he same policy

contrast, Plaintiffs in the present Action have pled both a non-exculpated breach of fiduciary duty and facts supporting their allegations, but the SCDs still seek to place the burden of proof of entire fairness on Plaintiffs at the pleading stage.

Accordingly, for the foregoing reasons, the Court should affirm the Court of Chancery's denial of the SCDs' motion to dismiss.

Dated: April 13, 2015

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rationale that subjects a transaction to judicial review for entire fairness, even if the burden of persuasion shifts, requires a finding of unfairness and the basis of liability for monetary damages, before the exculpatory nature of a *Section 102(b)(7)* provision is examined." It added that "[w]hen the standard of review is entire fairness, ab initio, director defendants can move for summary judgment on either the issue of entire fairness *or* the issue of burden shifting." *Id*. at 98-99 (emphasis added). *Southern Peru Copper* appears to imply that summary judgment may be available to special committee defendants in appropriate circumstances. That question is not the subject of this interlocutory appeal and need not and should not be considered at this juncture.