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Case Number 461,2013 D

IN THE SUPREME COURT OF THE STATE OF DELAWARE

SOUTHEASTERN PENNSYLVANIA TRANSPORTATION AUTHORITY, individually, and on behalf of all those similarly situated,	:	No. 461, 2013
Plaintiff-Below, Appellant,	:	Case Below:
v.	:	Court of Chancery
ERNST VOLGENAU, JOHN W. BARTER, LARRY R. ELLIS, MILES R. GILBURNE, W. ROBERT GRAFTON, WILLIAM T. KEEVAN, MICHAEL R. KLEIN, STANTON D. SLOANE, GAIL R. WILENSKY, SRA INTERNATIONAL, INC., PROVIDENCE EQUITY PARTNERS LLC, PROVIDENCE EQUITY PARTNERS VI L.P., PROVIDENCE EQUITY PARTNERS VI-A L.P., STERLING PARENT INC., STERLING MERGER INC. and STERLING HOLDCO INC.	:	C.A. No. 6354-VCN
Defendants-Below, Appellees.	:	

PLAINTIFF-BELOW, APPELLANT'S OPENING SUPPLEMENTAL MEMORANDUM

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A. Introduction

This Court's affirmance of *Kahn v. M&F*, No. 334, 2013 ("*M&F*") sets forth a very limited category of cases wherein controller mergers will be reviewed under the business judgment standard. This case does not fall within that very limited category. This action serves as a useful bookend, demonstrating the types of factual issues that, when present at the summary judgment stage, should not result in deference to the controller or board.

The entire fairness standard is applied as a substitute for statutory protections of disinterested board and stockholder approval because both protections are potentially undermined by the influence of a controller. *M&F* at 15-16. Rather than replicating an arm's-length process (as in *M&F*), the record reflects a process initiated, conducted and concluded in a fog of control. Volgenau did not "irrevocably and publicly disable[] [himself] from using [his] control to dictate the outcome of the negotiations." *M&F* at 16. Rather, Volgenau's interests and demands were front and center at every step to his taking SRA private, resulting in an unfair price for the minority and a windfall for Volgenau.[1]

In contrast, business judgment review is available "if and only if" there are

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[1] While this case differs from *M&F* because Volgenau did not initiate a specific offer, the analytical framework created by *M&F* applies. The process was not an arm's-length negotiation because Volgenau initiated the process after secret discussions with Providence, Volgenau was enabled to define the process by his interests and conditions, the Special Committee chairman had an undisclosed expectation of a personal reward upon delivering a transaction desired by Volgenau, minority stockholders were materially misled, and the Merger price was unfair.

no triable facts that the "dual protections" of a fair price achieved by an empowered, independent committee that acted with care and a fully informed majority of minority vote were in place. *M&F* at 17-18. Defendants have not established "as a matter of undisputed fact and law" the existence of dual protections. *M&F* at 20. The record reflects genuine issues of fact as to whether the SRA buyout by Volgenau and Providence satisfies the new standard and, thus, requires a trial under entire fairness review.

Further, the Court-below erroneously resolved facts in dispute and improperly reached conclusions regarding state of mind without live testimony. Op. Br. at 1, 23-32; Reply Br. at 6. The Court-below's errors also led, in part, to legal errors regarding Defendants' materially misleading disclosures.

B. Discussion

1. Volgenau Did Not Condition the Procession of the Merger on the Dual Protections *Ab Initio*

Defendants have not established that Volgenau committed, *ab initio*, to the dual protections articulated in *M&F* as an undisputed matter of fact and law.

Upon initiating the sale process, Volgenau did not condition a transaction on a majority of the minority vote.[2] A1680-3, 2641-45, 2740-53. Rather, it was not

[2] Volgenau's conduct leading to the formation of the Special Committee was not indicative of a controller intending to be hands-off. Volgenau had secret discussions with Providence giving Providence a long "head start" as Volgenau's "partner" (A290-301, 316-29, 339-40, 343-9, 361-2, 405-6, 408, 1276, 1424, 1425-36, 2574-92, 2596-600); he created and led the strategic

until March 21, 2011 -- at the final stages of the process -- that the concept of a majority of the minority vote was introduced. A1099. Further, although SRA formed a Special Committee that would be empowered to make a recommendation to the Board, the Board was not specifically prohibited from approving a transaction without a favorable recommendation from the Special Committee. *Compare* A2641-5 *to M&F* at 10.

2. The Special Committee Lacked Independence from Volgenau and Its Chairman, Klein, Was Interested in the Outcome

The Special Committee process lacked independence from Volgenau. Op. Br. at 14-20, 27-31; Reply Br. at 1, 10-14. Independence requires impartiality of the members and actual exercise of independence. *M&F* at 20-21, 20 n.18. In *M&F*, the controller was excluded from the special committee the process whereas Volgenau was expressly permitted a hands-on role, for example:

- The Special Committee sought Volgenau's approval to engage potential strategic bidders in the process. A1829, 1832. That approval was sought despite the fact that the scope of authority conveyed to the Special Committee by the Board clearly authorized Special Committee to do so without Volgenau's approval. A2642-44. Thus, even if the Special Committee were nominally

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"study team" but did not disclose the ongoing LBO discussions (A263, 379, 444, 469; B3-4); he determined that an LBO would best serve his idiosyncratic desires for SRA (A291, 1056-57); he determined to initiate the sale process (A2740-1); and he selected the majority of the members of the Special Committee (A381-2).

empowered to decide independently whether to engage strategic bidders, it did not function independently in that regard.

- Volgenau met off the record and alone with potential strategic bidders and discussed his conditions. A305, 307-8, 1871. He did so despite his belief (consistent with the stated views of Citi and senior SRA management) that his conditions would reduce available synergies from "sausage factories" and thus impact the price strategics would be willing to pay. A1055, 1576, 1801, 2746. The affidavits of potential strategic bidders submitted by Defendants do not negate the evidence that Volgenau imposed his conditions on the process including during these discussions.

- Volgenau remained in contact with DiPentima (paid both as an SRA consultant and by Providence) regarding the process despite having been directed not to do so. A401-3, 433, 1276, 2556-66; AR7-8, 54, 56-57, 59, 61.

- Volgenau provided Klein with negative information concerning Veritas' chairman as a potential partner just as it appeared Veritas might outbid Providence. AR33-38, 63. The Special Committee thereafter made additional demands on Veritas resulting in it leaving the process. B76-77.

The notion, floated for the first time by Defendants' counsel during argument, that the Special Committee could exercise independence by "waiting

out" Volgenau (Tr. at 31:4-24, 38:8-12)[3] is belied by the evidence that Klein actively and disloyally encouraged Volgenau to exploit his control over SRA before it expired to ensure Volgenau decided SRA's fate. A1056.

Beyond the Special Committee's failure to act independently from Volgenau's influence, Klein was affirmatively interested in the outcome of the process – the Merger. Klein harbored an undisclosed expectation for a windfall reward throughout the process.[4] A1993-95. His own words demonstrate his desire for the reward, his reasoning and experiences that led to his desire, and his disappointment in not receiving it.[5] *Id.* The record also reflects financial materiality of the proposed reward to at least one of the charities to which he desired his reward be directed. A1761, 2884 (showing the Shakespeare Theatre Company's cash on hand and pledged gifts). During oral argument, counsel for Defendants conceded that the memorandum Klein wrote demonstrates that the request was arguably "important" to him but disputed that the importance caused

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3 Plaintiff filed the oral argument transcript ("Tr.") on March 19, 2014.

4 As even the Court-below stated: "This type of request or expectation raises serious concerns about the objectivity of a special committee member. One can easily imagine how this practice, if adopted, could be fraught with potential abuse, especially when it is not disclosed to shareholders and directors who might have thought such significant compensation material..." SJ Op. at 41 n. 135.

5 Klein's affidavit (A2815-16), stating he did not receive the reward, does not establish Klein's disinterestedness during the course of the process leading to the Merger. Whether he won or lost his fight for the reward, his contemporaneous admission that he had an expectation is evidence concerning Klein's interestedness as he led the process. *Compare MFW* at 24 ("no record evidence that Dinh expected to be asked to join Revlon's board at the time he served on the Special Committee"). And, record evidence concerning new and increased contributions to the Shakespeare Theatre Company contradict Klein's Affidavit. A1765-66, 2820, 2884, 2887-8.

Klein to breach his duties. Tr. at 44:9-15. Counsel's assertion that the "importance" of the request did not cause Klein to breach his fiduciary duty of loyalty is a triable issue. *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1167 (Del. 1995).

M&F did not involve allegations that any outside director had an actual interest in the transaction at issue, but alleged the independence of the committee was compromised based on scant and circumstantial "evidence" of prior personal and business relationships with the controller. *See M&F* at 22-29. In contrast, Klein admitted his actual expectation for a *quid pro quo* payment that was dependent on satisfying Volgenau. Klein's memorandum to Volgenau even refers to the fact that the deal reached was the one Volgenau wanted. A1993-5.

In addition, each advisor had close ties to Klein and the Shakespeare Theatre Company to which Klein would seek his expected reward be paid. A1689, 1765-6, 1778, 2820, 2887-8. Moreover, each of Houlihan and Kirkland was provided incentives in its compensation package that would only be triggered if a deal were reached (satisfying Volgenau). A1112, 1782-3.

3. The Special Committee Was Restrained

Defendants have not established that the Special Committee was empowered as in *M&F* as a matter of undisputed fact and law.

The Special Committee had no power to make its recommendation "stick."

Any Special Committee recommendation of a strategic alternative for SRA remained subject to Volgenau's approval. Further, despite the clear authority conveyed to the Special Committee by the Board resolution, the Special Committee sought approval from Volgenau to engage strategic bidders. Thus, whatever nominal power was conveyed to the Special Committee, it functioned subject to Volgenau's approval.

In contrast, the *M&F* special committee was empowered to consider, negotiate and make a recommendation with respect to the controller's proposal and the Board was not permitted to proceed without a special committee recommendation. *M&F* at 10. And, there is no indication that the *M&F* special committee sought controller approval concerning its actions to evaluate the controller's proposal compared to the value of other alternatives.

4. The Special Committee Did Not Meet its Duty of Care to Negotiate a Fair Price

A fundamental touchstone of care in considering a transaction is reliable information concerning value. The Special Committee lacked and/or ignored reliable information because: Houlihan's valuation and analyses concerning the Merger were inconsistent with earlier data Houlihan provided to the Special Committee; the market check for potential bids from strategics was influenced by Volgenau's conditions; and the prior value information provided to the Board including by Citi and SRA management indicated an LBO was not the most

valuable alternative for SRA. The record reflects the Special Committee's and Houlihan's work on value was limited and result-driven.

The Court-below did not directly address the issue of whether the Board exercised care regarding negotiation of price.[6] Plaintiff, however, addressed the issue of price, including the dispute between the experts as to SRA's fair value, at length in its summary judgment brief. A200-16, 228-31. Given the facts in the record, the gap between the experts is not surprising.

First, Volgenau's conditions for a sale (*i.e.*, the preservation of SRA's "name, values and culture") impaired the ability of synergy-driven strategic buyers to offer full value for SRA. A1055-57, 1576, 1801, 2746. Volgenau admitted he communicated those conditions as part of the bifurcated process. A305, 307-8.

Second, Houlihan's work was manipulated to fit the bids on the table, which emerged from the process tainted by a controller and an interested Special Committee Chairman, rather than used as a negotiating tool to achieve fair value. Prior to the final two days of the process, Houlihan never provided a view as to fair value, but rather provided sets of data points. To enable it to opine as to the fairness of the $31.25 per share Merger consideration, Houlihan manipulated the data points previously provided to the Special Committee and utilized stale data.

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[6] The Court below decided that any care issues were mooted by 102(b)(7). This Court can address the care issue because the parties presented it below and this Court's jurisdiction permits it. Supr. Ct. R. 8; *Texlon Corp. v. Meyerson*, 802 A.2d 257, 263 (Del. 2002).

A211-13, A698-709, *Compare* A1659-74 *to* A2504-21. The Special Committee passively accepted Houlihan's manipulative changes to accommodate the outcome.

Third, because the Special Committee never obtained a view as to SRA's fair value, it had no frame of reference from which to negotiate, contrary to the committee in *M&F*. Instead the Special Committee accepted the highest remaining bid in the skewed and flawed process.

Fourth, the full Board's carelessness and, indeed, disloyalty is demonstrated by its failure to consider or to take any step to satisfy its obligation under the Certificate to ensure Volgenau's Merger consideration was equal per share to that of the minority stockholders despite it being substantially different in kind.

5. The Vote of the Minority Was Not Fully Informed

Unlike plaintiffs in *M&F*, Plaintiff here challenged the materially deficient and misleading disclosures made to SRA's minority stockholders. Op. Br. at 29-31; Reply Br. at 14-17. The incomplete disclosure related to compensation expectations of Klein and the Special Committee's counsel undermined minority stockholders' ability to rely on Defendants' representations regarding independence and disinterest. The amount of Klein's expected *quid pro quo* payment is many times greater than the amount of compensation disclosed or the amounts of compensation paid in comparable circumstances as provided to the

Board.[7] *Compare* A496-7, 1134, 1963, 1966-8 *to* A1993-5. Moreover, the disclosure that there would be no additional payments to Special Committee members is inconsistent with Klein's contemporaneous, live expectation and demand. Similarly, Kirkland had a payment structure including an incentive to earn a bonus if a deal satisfactory to Volgenau was struck.

C. Conclusion

Plaintiff respectfully submits that the Court's resolution of *M&F* and the standard articulated thereby support reversal of the Court-below. Material disputes of fact exist regarding whether the challenged SRA Merger featured an independent and disinterested Special Committee process and the Court-below erred as a matter of law in determining there was a fully informed vote of the minority. As such, this action should be remanded to proceed to trial under the entire fairness standard.

DATED: March 31, 2014

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[7] The Court-below erred by equating personal materiality to Klein with materiality to stockholders. SJ Op. at 35-41. Given counsel's concession of a triable fact regarding materiality to Klein, even under the Court-below's erroneous application of the materiality standard in the voting context, there is a question of fact regarding whether the minority was fully informed.

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