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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' REPLY BRIEF

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PRELIMINARY STATEMENT

The trial court improperly denied the Special Committee Directors' motion to dismiss by applying a rule of decision erroneously derived from this Court's decision in *Emerald Partners II*.[1] Under the rule applied by the trial court, a plaintiff challenging a merger transaction states a breach of fiduciary duty claim against disinterested and independent directors solely on the basis that an allegedly controlling stockholder entered into the transaction without satisfying the procedural requirements set forth in *M & F Worldwide*[2] for the controlling stockholder to receive business judgment review. The rule applies to disinterested and independent directors even if a plaintiff pleads no facts supporting an inference that those directors engaged in any non-exculpated conduct that would entitle the plaintiff to any relief from them.

Such a 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 must be reversed and remanded for an assessment of whether Plaintiffs alleged facts supporting an inference of a non-exculpated claim against each of the Special Committee Directors.

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[1] *Emerald Partners v. Berlin*, 787 A.2d 85 (Del. 2001) ("*Emerald Partners II*"). Unless otherwise indicated, defined terms appear as used in Appellants' Opening Brief. Appellees' Corrected Answering Brief is cited as "Ans. Br."

[2] *Kahn v. M & F Worldwide Corp.*, 88 A.3d 635 (Del. 2014).

Plaintiffs largely ignore that argument in their Answering Brief, and instead, attempt to recast the question presented, arguing that this Court must decide whether disloyal directors can be exculpated.[3] In doing so, Plaintiffs focus on the wrong issue and rest their argument on inapposite authority.

Plaintiffs' main argument is that this appeal is sufficiently similar to the currently-pending appeal in *In re Cornerstone Therapeutics Inc. Stockholders Litigation* that the Court can simply look to the arguments contained in the brief filed by the appellees in that case,[4] but Plaintiffs gain nothing from their procedural shortcut. They never explain why the *per se* rule applied by the trial court is required by *Emerald Partners*, let alone consistent with any of Court of Chancery Rule 8, settled Delaware law or good policy.

Instead Plaintiffs' argument rests primarily on out-of-context quotations from decisions of this Court and, more frequently, the Court of Chancery that Plaintiffs claim justify the application of a special set of guilt-by-association pleading standards to disinterested and independent directors in the context of a controlling stockholder transaction.[5] A closer examination of those

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[3] Ans. Br. at 14.

[4] *See* Ans. Br. at 16-18; *see also Ploof v. State*, 75 A.3d 811, 822-23 (Del. 2013) (holding issues incorporated by reference were not properly presented under Rule 14 and therefore waived, explaining that "incorporating arguments by reference … allows parties to ignore clearly established page limitations, leading to unfocused, ineffective arguments.").

[5] *See* Ans. Br. at 18-26.

decisions, however, demonstrates that they do not support Plaintiffs' position. Prime examples are Plaintiffs' failure to acknowledge the procedural posture of this Court's *Emerald Partners* decisions, failure to consider the context of this Court's decision in *M & F Worldwide*, which addressed the standard applicable to controlling stockholders, not special committee directors, and the procedural posture of this Court's decision *Kahn v. Tremont*,[6] which concluded the special committee directors were subject to entire fairness in a post-trial decision.

The remainder of Plaintiffs' brief advocating the adoption of a *per se* rule is devoted to unavailing policy reasons that do not confront the powerful policy reasons offered by the Special Committee Directors, rests on factual arguments that incorrectly presume that the question of whether the Special Committee Directors breached their duty of loyalty was addressed below, and incongruously argues that facts unique to this case somehow warrant the creation of a *per se* rule. For the reasons stated herein, each of those arguments should be rejected. This Court should reverse the trial court's decision and remand for consideration of whether Plaintiffs have alleged well-pled facts that would support the existence of a reasonably conceivable non-exculpated claim against each of the Special Committee Directors.

[6] 694 A.2d 422 (Del. 1997).

ARGUMENT

This appeal involves the application of one of the bedrock principles of Delaware law: directors of a Delaware corporation "are entitled to a *presumption* that they were faithful to their fiduciary duties."[7] A stockholder plaintiff can overcome that presumption and state a claim for money damages against a director for breach of fiduciary duty *only if* the plaintiff alleges that the director committed either a breach of the duty of loyalty or a non-exculpated breach of the duty of care.[8]

This Court has held that plaintiffs can meet their pleading burden in asserting claims *against a controlling stockholder* by alleging that the stockholder controlled the board of directors, stood on both sides of the transaction, and that the transaction was not entirely fair to the company.[9] However, this Court has never permitted plaintiffs to use such a claim against a controlling stockholder to bootstrap a fiduciary duty claim against disinterested and independent directors absent some well-pled factual allegation that those directors, on a separate and individualized basis, engaged in non-exculpated conduct. As explained in Appellants' Opening Brief, requiring the presence of such well-pled allegations is

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[7] *Beam ex rel. Martha Stewart Living Omnimedia, Inc. v. Stewart*, 845 A.2d 1040, 1048 (Del. 2004); *see also Gantler v. Stephens*, 965 A.2d 695, 705-06 (Del. 2009) (quoting *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984)).

[8] *Malpiede v. Townson*, 780 A.2d 1075, 1094 & n.65 (Del. 2001).

[9] *Kahn v. Lynch Commc'n Sys., Inc.*, 638 A.2d 1110, 1115 (Del. 1994).

consistent with the Court of Chancery Rules, corroborated by this Court's decisions, and consistent with good policy.

Although Plaintiffs argue that such a requirement is unfair to Zhongpin's unaffiliated stockholders,[10] there is nothing inequitable about placing the initial burden on Plaintiffs to plead a non-exculpated breach of fiduciary duty against each defendant. The presence of a well-pled claim for relief is the *sine qua non* for naming an individual as a defendant. Under settled Delaware law, plaintiffs bear the burden of pleading facts that overcome the presumption that "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."[11]

That standard is not altered where, as here, the directors are protected by a Section 102(b)(7) charter provision that exculpates them from monetary liability for duty of care claims. Although such a provision was initially treated for pleading purposes as "in the nature of an affirmative defense," this Court has since clarified that directors are not required to disprove the existence of loyalty claims

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[10] *See* Ans. Br. at 19-22.

[11] *Gantler*, 965 A.2d 705-06 (quoting *Aronson*, 473 A.2d at 812); *Cinerama, Inc. v. Technicolor, Inc.*, 663 A.2d 1156, 1162-64 (Del. 1995). Plaintiffs' suggestion (Ans. Br. at 32 n.21) that the presumption does not apply to direct claims misconstrues the Court of Chancery's decision in *iXCore, S.A.S. v. Triton Imaging, Inc.*, 2005 WL 1653942, at *1 (Del. Ch. July 8, 2005), which was distinguishing the notice pleading standard in direct actions from the particularized pleading standard applicable to derivative actions.

to successfully assert such a defense at the pleading stage.[12] Instead, plaintiffs seeking a monetary recovery against directors bear "the burden to plead facts that support the inference … that the directors engaged in non-exculpated conduct that result in damage."[13]

Plaintiffs, not the defendant directors, bear the burden of proving a non-exculpated breach of the duty of loyalty. Although Plaintiffs now suggest that they have satisfied that burden and that each of the Special Committee Directors was not independent, that issue was not addressed by the trial court and Plaintiffs concede that it is not before this Court on appeal.[14]

Plaintiffs next argue that this Court has created an exception to the well-established pleading standards described above in situations where a controlling stockholder stands on both sides of the transaction.[15] As explained in the Opening Brief, however, the Court has never approved such a rule and its decisions regarding controlling stockholder transactions have carefully avoided

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[12] *Compare Malpiede*, 780 A.2d at 1095 n.71 *with Emerald Partners v. Berlin*, 726 A.2d 1215, 1223-24 (Del. 1999) ("*Emerald Partners I*"). Indeed, commentators have recognized that the defense is more appropriately recognized as a statutory immunity. *See, e.g.*, William T. Allen, Jack B. Jacobs & Leo E. Strine, Jr., *Function over Form: A Reassessment of Standards of Review in Delaware Corporation Law*, 56 BUS. LAW. 1287, 1304-05 (2001).

[13] Allen, Jacobs & Strine, *supra* note 13, at 1305; *see also DiRienzo v. Lichtenstein*, 2013 WL 5503034, at *11 (Del. Ch. Sept. 30, 2014).

[14] Ans. Br. at 17-19 & n.12.

[15] Ans. Br. at 23.

conflating the pleading standards applicable to directors and controlling stockholders. That approach did not change in *M & F Worldwide*, which held only that the business judgment rule applies to *all* defendants, including the controlling stockholder, when certain conditions are present.[16]

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*."[17] In articulating that standard, this Court has never held that the disinterested and independent directors who approved 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.

Although this Court has applied the entire fairness standard of review to all defendants, including special committee directors, in the context of a controlling stockholder going-private transaction, it has done so *only* in cases where the plaintiff has pled facts calling into question the disinterestedness and independence of the directors on the special committee such that there was a *bona*

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[16] 88 A.3d at 645.

[17] *Lynch*, 638 A.2d at 1117 (emphasis added); *see also* Op. Br. at 15 n.24 (citing cases from this Court holding that burden of entire fairness falls on the stockholder who stands on both sides of the transaction, not disinterested and independent directors who approve it).

fide question regarding loyalty.[18] There is good reason for distinguishing the standard applicable to the controlling stockholder standing on both sides of a transaction, on one hand, and the disinterested and independent directors who approve the transaction, on the other.[19] The entire fairness standard works for the controlling stockholder because her subjective good faith is irrelevant – she is interested in the transaction because she stands on both sides of it and can manipulate its terms by virtue of her control over the board of directors. She therefore breaches her duty of loyalty if the transaction is unfair.[20]

But those facts are distinct from those necessary to state a claim against disinterested and independent special committee directors who do not stand on both sides of the transaction.[21] Even post-trial, the directors' liability for

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[18] *See, e.g.*, *Emerald Partners I*, 726 A.2d at 1222 (holding entire fairness would apply to special committee directors because the plaintiff's disclosure claim against the special committee directors, which implicated the duty of loyalty, was intertwined with the entire fairness claim regarding the transaction); *Kahn v. Tremont Corp.*, 694 A.2d 422, 428-29 (Del. 1997) (post-trial decision) *affirming* 1994 WL 162613, at *3-5 (Del. Ch. Apr. 22, 1994) (holding that entire fairness would apply to all defendants, in part because the court found that the plaintiff had sufficiently pled facts calling into question the disinterestedness and independence of the directors on the special committee).

[19] Op. Br. at 16-17.

[20] *See Venhill Ltd P'ship v. Hillman*, 2008 WL 2270488, at *22 (Del. Ch. June 3, 2008); *In re Southern Peru Copper Corp. S'holder Deriv. Litig.*, C.A. No. 961-VCS, at 41 (Del. Ch Dec. 21, 2010) (TRANSCRIPT).

[21] *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 Lt'd P'ship*, 2008 WL 2270488, at *22.

negotiating or facilitating such a transaction will hinge not on whether the transaction was entirely fair, but on whether the plaintiff successfully proved that each particular director engaged in a non-exculpated breach of his or her fiduciary duties.[22] Only the controlling stockholder is strictly liable as the guarantor of the fairness of the transaction.

Plaintiffs argue that there have been decisions from the Court of Chancery that support the *per se* rule for which Plaintiffs advocate. But those decisions proceed from a misreading of *Emerald Partners* and from the premise that, in transactions in which a controlling stockholder stands on both sides, there is a "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."[23] That premise, however, is inconsistent with the settled presumption that directors will act in a way that is faithful to their fiduciary duties and has been mitigated by more modern developments. Considerations such as reputational embarrassment and modern technology, with the latter enabling the advisors of institutional investors to track decisions made by individual directors, incentivize independent directors to "procure a deal that their minority

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[22] *Southern Peru*, 52 A.3d at 787 n.72 ("The fact that the transaction is found to be unfair is of course relevant, but hardly sufficient, to that separate, individualized inquiry.").

[23] *See, e.g.*, *Quadrant Structured Products Co. v. Vertin*, 102 A.3d 155, 194 (Del. Ch. 2014); *In re Pure Res., Inc. S'holders Litig.*, 808 A.2d 421, 436 (Del. Ch. 2002).

stockholders think is a favorable one."[24] The *per se* rule adopted by the trial court ignores this modern reality and creates a "dubious presumption" that a disinterested director would "sell his or her soul" for a controlling stockholder.[25] There are, in fact, significant examples of independent directors taking actions contrary to the desires of a controlling stockholder.[26]

Finally, Plaintiffs advance a series of policy arguments as justifications for the *per se* rule applied by the trial court.

First, Plaintiffs advocate for the *per se* rule so that they can use discovery to fish for facts that will support their claims.[27] This Court, however, has routinely admonished that discovery is not to be used in such a manner, and that stockholders should use pre-suit fact-gathering tools at their disposal to develop the necessary facts to support a claim.[28] Plaintiffs failed to use the tools at

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[24] *In re MFW S'holders Litig.*, 67 A.3d 496, 529 (Del. Ch. 2013) *aff'd*, 88 A.3d 635 (Del. 2014).

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

[26] *See Next Level Commc'ns, Inc. v. Motorola, Inc.*, 834 A.2d 828, 846-47 (Del. Ch. 2003) (majority independent board, in response to controlling stockholder tender offer, formed special committee excluding controller's designees and recommended stockholders not tender); *In re CNX Gas Corp. S'holders Litig.*, 4 A.3d 397, 413 (Del. Ch. 2010) (noting examples of independent directors acting contrary to the wishes of a controlling stockholder, including adoption of a rights plan and litigation in response to a tender offer by Royal KPN).

[27] *See* Ans. Br. at 26-28.

[28] *Beam*, 845 A.2d at 1056; *see also, e.g.*, *Brehm v. Eisner*, 746 A.2d 244, 266 (Del. 2000); *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." (citations omitted)).

hand, and should not be permitted to use the discovery process to search for a viable claim against the Special Committee Directors.

Second, Plaintiffs claim that anything other than the *per se* rule applied by the trial court will "open a wide berth in a safe harbor for disloyal directors."[29] But Plaintiffs do not explain why holding plaintiffs who sue directors in a controlling stockholder transaction to the same pleading requirement that exists for *every other transaction* – the requirement to provide a short and plain claim for relief against each defendant – will lead to disloyalty that escapes judicial review. Moreover, stockholder plaintiffs will be free to seek discovery from disinterested and independent directors as to whom they have no claim and, if the facts support a claim that a particular director was beholden to the controlling stockholder, those plaintiffs will be free to amend and add such a director as a defendant where there will be a cognizable non-exculpated claim. And in the event there is no basis for asserting a claim against a disinterested and independent director, the unaffiliated stockholders will not be without a remedy. The controlling stockholder will still serve as the guarantor of the fairness of the transaction and cannot escape entire fairness review absent the presence of the procedural protections described by this Court in *M &F Worldwide*.

[29] *See* Ans. Br. at 28.

Third, Plaintiffs' reference to *In re China Security & Surveillance Technology, Inc. Shareholders Litigation* is inapposite.[30] In the cited colloquy, which occurred at a settlement conference in which the plaintiff was attempting to justify the dismissal of substantively similar claims – the Vice Chancellor's reference to a "creepy business that we need to end" was about the potential perils of a reverse merger with a public shell, a type of transaction that is not the basis for Plaintiffs' claims or even referred to in the Complaint.[31] As to the claims being settled, while the Court did address some concern about the plaintiffs' agreeing to settle claims against the controlling stockholder that stood on both sides of the transaction and the special committee that approved the transaction, the Court did not address the pleading standards applicable to the plaintiffs' claims or comment on whether those claims would withstand a motion to dismiss.[32]

Fourth, Plaintiffs argue that they should not have to be bothered by issues such as director independence at the pleading stage and speculate regarding the reasons why the Special Committee Directors, who comprised the entirety of Zhongpin's nominating and governance committee, were selected.[33] That

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[30] *See* Ans. Br. at 28-30.

[31] *In re China Sec. & Surveillance Tech., Inc. S'holders Litig.*, C.A. No. 6279-CS, at 25 (Del. Ch. July 10, 2012) (TRANSCRIPT).

[32] *Id.* at 69-70.

[33] *See* Ans. Br. at 30-31.

speculation does nothing to overcome the basic presumption that the directors of a Delaware corporation "are entitled to a presumption that they were faithful to their fiduciary duties." Given that settled law, Plaintiffs were free to use the tools at hand to develop a factual basis to challenge the independence and good faith of the Special Committee Directors. Plaintiffs did not, and should not be permitted to invoke a *per se* rule to excuse their failure to do so.

CONCLUSION

For the reasons stated here and in Appellants' Opening Brief, the trial court's *per se* rule is inconsistent with Chancery Rule 8, contravenes several fundamental strands of Delaware's corporate law, including the presumption that Delaware directors act in good faith, and disincentives the use of disinterested and independent special committees. Nor was the trial court's *per se* rule required by this Court's decision 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 each of the Special Committee Directors.

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CERTIFICATE OF SERVICE

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