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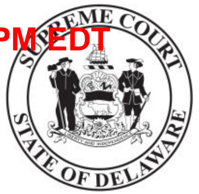

IN THE SUPREME COURT OF THE STATE OF DELAWARE

SALIX PHARMACEUTICALS, LTD. STOCKHOLDER LITIGATION

ROBERTA FEINSTEIN and REX GONSALVES,

Plaintiffs Below, Appellants,

v.

JOHN F. CHAPPELL, THOMAS W. D'ALONZO, WILLIAM P. KEANE, MARK A. SIRGO, VALEANT PHARMACEUTICALS INTERNATIONAL, INC., VALEANT PHARMACEUTICALS INTERNATIONAL, and SUN MERGER SUB, INC.,

Defendants Below, Appellees.

No. 308, 2016

On Appeal from C.A. No. 10721-CB in the Court of Chancery of the State of Delaware

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NATURE OF PROCEEDINGS

Plaintiffs-appellants ("Plaintiffs") were stockholders of Salix Pharmaceuticals, Ltd. ("Salix" or the "Company") before Valeant Pharmaceuticals International, Inc. ("Valeant," and with its affiliates, the "Valeant Defendants") acquired Salix through an all-cash tender offer worth $173 per share (the "Acquisition"). Plaintiffs filed suit in the Court of Chancery, alleging breaches of fiduciary duty against Salix's board of directors (the "Board") and aiding and abetting against the Valeant Defendants.

Plaintiffs allege that the Board rushed to sell the Company after news emerged that Salix's then CEO and CFO misled investors by understating Salix's bloated inventories. Moreover, after initially agreeing to sell the Company to Valeant for $158 per share pursuant to the Agreement and Plan of Merger dated February 20, 2015 (the "Merger Agreement"), the Board eschewed a third-party topping offer worth $175 per share to re-up with Valeant at $173 per share through an amendment to the Merger Agreement dated March 16, 2015 (the "Amendment"). In so doing, the Board agreed to a coercive step-down provision whereby the Acquisition price would drop from $173 back down to the original $158 if *for any reason* the Acquisition was not completed by April 8, 2015 (the "Step-Down Provision"). Further, just days before the tender offer expired, the Board terminated roughly $39 million in equity awards that would have been payable to the former CEO and CFO, thus conferring a

windfall for Valeant without Salix stockholders receiving anything in return. The Board also failed to disclose material information regarding the Acquisition.

The Delaware Court of Chancery correctly analyzed Plaintiffs' claims under heightened scrutiny—it expressly declined Defendants' invitation to hold that shareholder approval of the Acquisition invoked the business judgment rule—but the Court of Chancery misapplied the law, misconstrued the facts alleged in Plaintiffs' complaint, and ignored the real coercive circumstances facing Salix stockholders. Specifically, the Court of Chancery erroneously held that Plaintiffs were unable to demonstrate bad faith in violation of the Board's *Revlon* duties in connection with the termination of the unvested equity awards which benefitted Valeant and not the Salix stockholders. Moreover, regarding the Step-Down Provision, the Court of Chancery erroneously focused on whether there was disparate treatment among Salix stockholders, ignoring the principles established by a swath of Delaware case law, the real life coercive implications of such a provision, and the temporal problems with a rigid disparate treatment approach, which implies an after-the-fact perspective as opposed to considering what stockholders thought at the time of the tendering decision. Plaintiffs submit that the Court of Chancery's conclusions were in error and that its final judgment should be reversed.

SUMMARY OF ARGUMENT

1. The Court of Chancery erred in holding that Plaintiffs had not alleged that the Board acted in bad faith in connection with the equity award termination. The Court of Chancery failed to recognize that, under *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,[1] the Salix Board was obligated to get the highest price reasonably available, yet the Board willingly gave away $39 million in consideration to Valeant just days before the tender offer expired.

2. The Court of Chancery erred in holding that the tender offer structure, as provided for by the Amendment, was coercive. Delaware's courts have held that tender offers are coercive when, as a practical matter, "no rational shareholder could afford not to tender."[2] Here, given the implications of the Step-Down Provision, particularly in light of the Board's rejection of a superior offer and the circumstances leading up to the Acquisition, the tender offer was coercive.

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[1] 506 A.2d 173, 184 n.16 (De. 1986).

[2] *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, 519 A.2d 103, 113 (Del. Ch. 1986).

STATEMENT OF FACTS

I. FACTS UNDERLYING PLAINTIFFS' CLAIMS

Salix is a specialty pharmaceutical company that develops pharmaceutical products for treating and preventing gastro-intestinal (GI) disorders.[3] The Company's website lists twenty-three different products that the Company has licensed, marketed, or developed for the treatment of a wide variety of GI disorders, thus making it a well-established company with a steady stream of revenue-generating products and a consistent record of meeting or exceeding market expectations.[4]

On June 27, 2014, Allergan, Inc. ("Allergan") said it was interested in purchasing Salix for $180 per share ($22 per share more than what the Board originally agreed to accept from Valeant and $7 more than the ultimate Acquisition price), subject to due diligence.[5] On August 13, 2014, after retaining Centerview Partners ("Centerview") as its financial advisor, the Board unanimously decided that Allergan's $180 per share offer "was insufficient [even] to form the basis for discussions between the parties . . . ."[6] On August 20, 2014, Allergan increased its

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[3] A-19, ¶ 1. (All citations to "¶" are to paragraphs of Plaintiffs' Verified Second Amended Class Action Complaint.)

[4] A-31–A-35, ¶¶ 39-49.

[5] A-36–A-37, ¶ 58.

[6] A-37, ¶ 61.

offer to $200 per share, and six days later Allergan increased its offer again, to $205 per share, in exchange for three weeks of exclusivity.[7]

On September 4, 2014, Allergan expressed concern about Salix's in-channel inventory data.[8] On September 15, 2014, Allergan further advised Salix that it was concerned about wholesaler inventory levels for the Company's key products and that it had to examine these issues before engaging in further discussions.[9] Thus, by at least September 15, 2014, the Board knew about potential issues with the Company's inventory levels, which were concealed until November 6, 2014.[10]

Meanwhile, after vetting Salix's inventory data, Allergan was still interested in acquiring the Company, offering $175 per share on September 23, 2014.[11] That same day, Actavis plc ("Actavis") also expressed interest in acquiring Salix but failed to indicate a potential range of prices.[12] One day later, the Board resolved to tell Allergan that it was "not even willing to discuss a transaction" at $175 per share, yet it permitted Actavis to commence due diligence.[13]

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[7] A-37–A38, ¶¶ 62-63. Importantly, it was public knowledge that Allergan was fending off hostile takeover attempts and, in connection therewith, was exploring its own alternatives.

[8] A-38, ¶ 64.

[9] *Id.*

[10] A-38–A39, ¶¶ 64, 66.

[11] A-39, ¶ 66.

[12] *Id.*

[13] A-39–A-40, ¶¶ 67, 70.

The Board's rejection of Allergan came several weeks before it even began investigating, much less completed any review of, the alleged inventory problems.[14] Indeed, not until October 14, 2014—more than a month after Allergan expressed concerns over the inventory levels, and only after rejecting a bid that exceeded the eventual $173 per share Acquisition price—did the Board direct its Audit Committee to conduct a review into the inventory issues.[15] This review was not publicly disclosed until early November 2014.[16] During the intervening period, Actavis submitted an offer in the form of a mix of cash and stock for between $178 and $185 per share.[17]

On November 6, 2014, in connection with its third quarter earnings release, Salix finally divulged what Allergan had discovered two months earlier—that the Company's reported wholesaler levels for certain key products far exceeded the amounts indicated by the Company's CFO, Adam Derbyshire ("Derbyshire"), on previous investor calls.[18] The Company also announced that Derbyshire was resigning pursuant to an agreement with the Company, but leaving with direct

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[14] A-39, ¶ 68.

[15] A-42, ¶ 76.

[16] A-42, ¶ 77.

[17] A-41, ¶ 73.

[18] A-42, ¶ 78.

compensation and outstanding equity awards worth over $34 million.[19] Per the agreement, the Company retained the ability to claw back or terminate his direct compensation and much of his equity compensation under certain circumstances, including if Derbyshire committed intentional misconduct harmful to the Company or was found to have violated the federal securities laws.[20]

Shortly after the November 6, 2014 revelation, circumstances led the Board to embark on a process to sell the Company.[21] Specifically, Salix's stock took a short-term tumble. Moreover, on November 17, 2014, Allergan and Actavis, the Company's only two serious bidders at the time, announced that they had agreed to merge,[22] thus stripping away any negotiating advantage the Board thought it had with either party and putting the Board into panic mode.[23] The very next day, the Board held a special meeting and decided to sell the Company.[24]

During the ensuing process, the Board authorized Salix to contact only 5 of the 14 parties identified by Centerview.[25] On December 30, 2014, then-CEO, Carolyn J. Logan ("Logan") abruptly retired, with the Board agreeing to pay Logan an

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[19] A-43, ¶ 79.

[20] *Id.*

[21] A-48, ¶ 91

[22] A-51, ¶ 98.

[23] A-51, ¶ 99

[24] A-51, ¶ 100.

[25] A-52–A53, ¶ 105.

undisclosed cash severance award.[26] According to a Form 4 filed with the SEC, Logan also owned over $174 million worth of Salix stock at the time of the Acquisition, much of which represented compensation from the Company.[27] The Board never attempted to claw back such compensation, which resulted in a windfall to Logan that should have gone to the Company stockholders.[28]

On January 28, 2015, Salix shocked the marketplace by announcing that the Company's previously issued audited consolidated financial statements for the year ended December 31, 2013, and the previously issued unaudited consolidated financial statements for the fiscal quarters ended March 31, June 30, and September 30, 2014, should no longer be relied upon.[29] The result of the Audit Committee's investigation concluded that a litany of accounting errors occurred, including extensive improper revenue recognition and certain misclassification of expenses.[30]

Based on the substance of the restatement, the accounting errors were very likely intentional in nature.[31] For example, capitalizing a cost rather than expensing it resulted in artificially inflated income in the short term.[32] Likewise, misclassifying an

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[26] A-53–A-54, ¶ 107.

[27] *Id.*

[28] A-54, ¶ 108.

[29] A-57–A-58, ¶¶ 121, 123.

[30] A-58–A61, ¶¶ 124, 127.

[31] A-62, ¶ 129.

[32] *Id.*

item as cash flow from operations rather than from investing activities created the appearance that the Company's operations, the most important cash generating metric to the investing public and market professionals, was performing better than it actually was.[33] Similarly, misclassifying short-term debt as long-term debt distorted the analysis of the Company's solvency and creditworthiness, which affected the company's perceived cost-of-capital.[34] These errors reflect not innocent mistakes but, rather, widespread, intentional tampering with financial data.

These accounting errors forced Salix, among other things, to restate net income and net product revenue ("NPR").[35] In fact, for 2013, net income was overstated by $11.8 million and NPR by over $20 million.[36] According to the Company's 2014 annual proxy statement, the Company's financial performance (including namely revenue and profitability) and stock performance formed the basis for the Compensation Committee's awarding over $9 million in cash bonuses (not to mention other types of consideration) to Salix executives.[37] Such compensation was based on bogus numbers and should have been clawed back but never was.[38]

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[33] *Id.*

[34] *Id.*

[35] A-62–A-63, ¶¶ 130-131.

[36] *Id.*

[37] A-64, ¶ 133.

[38] A-64–A-65, ¶¶ 133-134.

Following these accounting revelations, the Board resolved to sell the Company as swiftly as possible to avoid derivative liability for breach of fiduciary duty.[39] Less than a month later, and only two months after the November meeting where the Board decided to sell the Company, the Board approved (with Defendant Chappell dissenting) Valeant's $158 per share offer. Salix and Valeant announced the Acquisition on February 22, 2015.[40]

Valeant commenced the tender offer on March 4, 2015, setting an expiration date of April 1, 2015 at midnight (one minute after 11:59 p.m. on March 31, 2015).[41] The blatant insufficiency of the consideration offered in the tender offer manifested itself when, on March 11, 2015, Endo submitted a competing offer for Salix worth a total of $175 per share, consisting of 1.4607 shares of Endo common stock and $45 in cash for each share of Salix common stock.[42]

As a result of Endo's topping offer, Valeant amended its bid to, among other things, (i) provisionally increase the consideration from $158 per share to $173 per share in cash (a 9.5% increase), (ii) increase the termination fee from $356.4 million to $456.4 million (a nearly 30% increase), and (iii) accelerate the outside date for

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[39] A-65, ¶ 136.

[40] A-66–A-67, ¶¶ 143-144.

[41] A-69, ¶ 153.

[42] A-69, ¶ 155.

completing the Acquisition from August 20, 2015 to May 1, 2015.[43] The Board also agreed to a Step-Down Provision, whereby, if the Acquisition were not completed by April 8, 2015 for any reason, Valeant would reduce its offer back to the original (and still inadequate) $158 per share, thereby coercing Salix stockholders to acquiesce to the unfair Acquisition or risk getting an even more unfair deal.[44] Despite Endo's $175 per share offer, the Board obligated itself to recommend the Acquisition with Valeant even if the consideration reverted to $158 per share.[45]

On March 25, 2015, while the tender offer was pending, and as a result of Plaintiffs' efforts, the Board decided to terminate $39 million in equity awards previously granted Derbyshire and Logan (thus saving Valeant the expense of purchasing those shares).[46] The Board, however, failed to ensure that any of this amount was fairly apportioned to the Company's stockholders.[47] Instead, the $39 million equity award termination provided a windfall to Valeant, reducing the purchase price by $39 million as a practical matter.[48]

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[43] A-20, ¶ 5, A-70–A-71, ¶ 161.

[44] A-20, ¶ 5, A-71, ¶ 162. The record contains some inconsistencies with respect to the dates relating to Step-Down Provision. Accordingly, Plaintiffs have in certain instances corrected the dates referenced, designating such corrections in brackets.

[45] *Id.*

[46] A-71–A-72, ¶¶ 166-167.

[47] A-72, ¶ 167.

[48] A-72, ¶ 169. Absent discovery, it is impossible to say whether this $38 million gift to Valeant occurred before or after the tender offer's minimum condition was met.

Seeing the potential liability due to its role in the restatements and bloated inventory levels, as a result of Plaintiff Feinstein's litigation demand and a pending securities fraud class action (the "Securities Action"), the Board quickly acquiesced to the Acquisition.[49] The Board faced potential liability prior to entering into the Merger Agreement for (i) failing to have accounting controls in place in order to ensure proper estimates of wholesaler inventory levels and manage those inventory levels; (ii) making unreasonable decisions regarding the compensation paid or payable to Logan or Derbyshire; (iii) failing to oversee the Company's questionable accounting practices, which resulted in a massive restatement affecting fiscal year 2013 and the first three quarters of 2014; (iv) concealing the bloated inventory for almost two months; and (v) dragging their feet in conducting an investigation into the inventory issues identified by Allergan in mid-September 2014.[50]

In addition to extinguishing their own liability, the Salix Defendants got to cash out, receiving a financial windfall.[51] It is estimated that the four directors at the time of the Acquisition collectively owned stock and other equity having a value of approximately $92.4 million—Sirgo ($5.5 million), Chappell ($55.8 million),

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[49] A-73–A-74, ¶¶ 173-174.

[50] A-73–A-74, ¶ 174.

[51] A-74, ¶ 176.

D'Alonzo ($22 million), and Keane ($9.1 million).[52]

Additionally, the Board failed to account for the roughly $39 million of equity awards which had previously been given to former Salix executives, awards that were terminated by the Board after entering into the Merger Agreement in response to Plaintiffs' demands.[53] By failing to do so, the Board did Valeant's bidding and succeeded in saving it approximately $39 million without securing any additional consideration for Salix's stockholders.[54] The Board sacrificed Salix's stockholders in favor of Valeant—this represents clear-cut bad faith and waste.[55] Further, the Board's termination of Logan's and Derbyshire's equity awards demonstrate that the derivative claims have value. In order to have terminated those awards, the Board had to find intentional misconduct that harmed the Company.

II. PROCEDURAL HISTORY

Beginning on February 25, 2015, six class action complaints were filed challenging the acquisition of Salix by Valeant. They are: (i) *Feinstein v. D'Alonzo, et al.*, C.A. No. 10721-CB; (ii) *Garcia v. D'Alonzo, et al.,* C.A. No. 10728-CB; (iii) *Gonsalves v. D'Alonzo, et al.*, C.A. No. 10737-CB; (iv) *Lindgren v. D'Alonzo, et al.,* CA No. 10748-CB; (v) *Zhang v. D'Alonzo, et al.*, C.A. No. 10760-CB; and (vi)

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[52] *Id.*

[53] ¶ 194.

[54] ¶ 196.

[55] *Id.*

Herlson v. D'Alonzo, et al., C.A. No. 10784-CB.

These six cases were consolidated by order of the Court of Chancery on March 17, 2015, and co-lead counsel appointed. On March 18, 2015, Plaintiffs moved for both expedited proceedings and a preliminary injunction.[56] On March 19, 2015, Plaintiffs filed a Consolidated Amended Complaint.

Plaintiffs thereafter on August 28, 2015, moved for leave to file a second amended complaint. Defendants did not oppose the motion and the Court of Chancery granted the motion on September 18, 2015. After meeting and conferring, the parties submitted a proposed scheduling order, which was entered by the Court of Chancery on September 24, 2015.

Plaintiffs filed the Second Amended Complaint on September 25, 2015. The parties fully briefed the two motions to dismiss and oral argument was held on May 19, 2016 and the Court of Chancery ruled from the bench dismissing the Second Amended Complaint in its entirety. This appeal followed.

[56] After the motions for expedited proceedings and a preliminary injunction were fully briefed, Plaintiffs withdrew the motions. As Plaintiffs explained at oral argument on the motion to dismiss, Plaintiffs feared that any delay from an injunction would trigger the coercive Step-Down Provision.

ARGUMENT

I. THE COURT OF CHANCERY ERRED IN FINDING THAT THE BOARD MEMBERS DID NOT BREACH THEIR FIDUCIARY DUTIES IN CONNECTION WITH THE EQUITY TERMINATION

A. Question Presented

Whether the Salix Board's termination of the unvested equity awards to Derbyshire and Logan rendering a windfall to Valeant that should have inured to the benefit of Salix stockholders amounts to bad faith contrary to *Revlon*'s mandate that the duty of the Salix Board was to "sell the company at the highest price attainable for the stockholders' benefit."[57]

B. Standard of Review

"A motion to dismiss a complaint presents the trial court with a question of law and is subject to *de novo* review by this Court on appeal."[58] Further, when reviewing a ruling on a motion to dismiss, this Court, like the trial court, "(1) accept[s] all well pleaded factual allegations as true, (2) accept[s] even vague allegations as 'well pleaded' if they give the opposing party notice of the claim, (3) draw[s] all reasonable inferences in favor of the non-moving party, and (4) do[es] not affirm a dismissal

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[57] A-1076-77.

[58] *Stifel Fin. Corp. v. Cochran*, 809 A.2d 555, 557 (Del. 2002) (citing *Malone v. Brincat*, 722 A.2d 5, 9 (Del. 1998)); *Chavous v. State*, 953 A.2d 282, 286 n.15 (Del. 2008) ("[W]e review the trial judge's determinations *de novo* for errors in formulating or applying legal precepts.").

unless the plaintiff would not be entitled to recover under any reasonably conceivable set of circumstances."[59]

C. Merits of Argument

Plaintiffs allege that the Board members breached their fiduciary duties in connection with their decision to terminate Derbyshire's and Logan's unvested equity awards, which were worth approximately $39 million, just before the tender offer expired. The Board's action provided an unjustified windfall to Valeant by reducing the aggregate Acquisition consideration by that same amount.[60] Salix stockholders should have received this benefit, not Valeant, and contrary to the Chancery's Court finding that such conduct fails to demonstrate "disloyalty or bad faith," the Board's conduct amounted to bad faith conduct in violation of *Revlon*.[61]

1. *Revlon* Duties, Standard of Review, and Good Faith

Under *Revlon*, once a board determines to sell the company, the duty of the board changes from preserving the corporate entity to maximizing the company's value for the benefit of its stockholders.[62] The directors' role changes from defenders of the company to auctioneers charged with getting the best price available for the

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[59] *Cent. Mortg. Co. v. Morgan Stanley Mortg. Capital Hldgs., LLC*, 27 A.3d 531, 535 (Del. 2011) (citations omitted).

[60] Derbyshire's unvested equity awards totaled $9,337,502, while Logan's totaled $29,463,457. A-72, ¶ 167.

[61] A-1076.

[62] 506 A.2d at 182.

stockholders at a sale of the company.[63] The role is an active one, and the directors' duty is selling the company at the "highest price attainable for the stockholders' benefit."[64] Under this enhanced scrutiny standard of review, "defendants bear the initial burden of showing that their decision-making process and actions were reasonable."[65] Here, the Salix Board cannot make the requisite showing of good faith by preferring and accommodating Valeant and consciously ignoring its fiduciary duties to the Company's stockholders.[66]

2. The Salix Board Acted in Bad Faith by Terminating the Equity Awards, Thus Benefitting Valeant, Without Conferring Any Benefit to Salix Shareholders

On November 17, 2014, the Company's only two suitors at the time, Allergan and Actavis, announced that they had entered into a merger agreement whereby Actavis would acquire Allergan.[67] The day after the Allergan-Actavis announcement, the Salix Board began to consider launching a sale process.[68] By November 22, 2014,

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[63] *Id.*

[64] *Id.* at 184 n.16; *see also Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 242-44 (Del. 2009) ("The duty to seek the best available price applies only when a company embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control."); *see also Chen v. Howard-Anderson*, 87 A.3d 648, 667-68 n.8 (Del. Ch. 2014).

[65] *In re Novell, Inc. S'holder Litig.*, 2014 Del. Ch. LEXIS 249, at *20 (Del. Ch. Nov. 25, 2014).

[66] *Revlon*, 506 A.2d at 182.

[67] A-51, ¶ 98.

[68] A-51, ¶ 100.

the Salix Board commenced the sale process.[69] It was at this point that the Salix Board's *Revlon* duties kicked in. Once the Salix Board's *Revlon* duties commenced, "the board's duty of loyalty require[d] it to try in good faith to get the best price reasonably available . . . ."[70] Here, that did not happen.

At the time that its *Revlon* duties commenced, the Board was aware of the following relevant facts: (i) on August 20, 2014, Allergan indicated to the Salix Board that it was willing to offer up to $200 per share, and then raised it to $205 on August 26, 2014, subject to three weeks of exclusivity, which was granted by the Salix Board;[71] (ii) by mid-September 2014, the Salix Board was aware that Allergan had expressed concern about the Company's wholesaler inventory levels but was still willing to offer $175 per share;[72] (iii) on October 14, 2014, the Salix Board directed its audit committee to conduct a review into the inventory issues;[73] (iv) on November 6, 2014, Salix announced that its wholesaler inventories for certain key products far exceeded the amounts publicly reported by Salix CFO Derbyshire; and (v) that Derbyshire was resigning pursuant to an agreement whereby the Company retained the ability to terminate his unvested equity awards based on Derbyshire having

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69 A-51–A-52, ¶ 102.

70 *Equity-Linked Inv'rs, L.P. v. Adams*, 705 A.2d 1040, 1054 (Del. Ch. 1997).

71 A-37–A-38, ¶¶ 62-63.

72 A-38–A-39, ¶¶ 64, 67.

73 A-42, ¶ 76.

committed intentional misconduct harmful to Salix or was found to have violated the federal securities laws.[74] Thus, at the time *Revlon* was triggered, the Board was aware of the wholesaler inventory issues, had commenced its audit committee investigation and parted ways with Derbyshire under an agreement giving the Salix Board the ability to terminate Derbyshire's unvested equity awards upon the Board's finding that he had engaged in intentional misconduct harmful to the Company. The Salix Board's failure to terminate Derbyshire's unvested equity awards even at this stage—and any point up to the execution of the Merger Agreement—is a breach of its *Revlon* duties to get the best price for the Company's stockholders and demonstrates the lack of good faith.

Subsequent developments provide an even more compelling justification for the Board to have terminated the unvested equity awards in its search for maximum stockholder value under *Revlon.* On December 30, 2014, Logan, the Company's CEO, resigned and also signed a similar agreement as Derbyshire permitting termination of her unvested equity awards.[75] On January 8, 2015, Appellant Feinstein issued a litigation demand, which the Board responded to on January 19, 2015, promising to bring her concerns to the Board's attention at an upcoming meeting.[76]

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[74] A-42–A-43, ¶¶ 78-79.

[75] A-53–A-54, ¶ 107, A-71, ¶ 165.

[76] A-43–A-44, ¶ 80.

Then on January 28, 2015, Salix shocked the marketplace by announcing a restatement for the year ended December 31, 2013, and fiscal quarters ending March 31, 2014, June 30, 2014, and September 30, 2014. Based on the substance of the restatement, the accounting irregularities appeared to be intentional in nature.[77]

Despite the overwhelming amount of evidence against Logan and Derbyshire, the Board did nothing. At least not until Valeant came along. Indeed, after entering into the Merger Agreement, and just days before the tender offer expired, the Board held a special meeting and decided to gift Valeant a $39 million discount vis-à-vis the equity award termination. Yet stockholders, on whose behest the Board should have been acting, received nothing.

The Board's decision to terminate the unvested equity awards had no impact on Salix's overall value. Indeed, had the Board done this before entering into the Merger Agreement, it would have simply changed the denominator. Rather, since Valeant had locked in a per share price, Valeant knew it would reap tangible rewards if the Board slashed the share count. The fewer shares it had to purchase at a preset price simply meant it did not have to pay as much to buy the Company.

Here, "[w]here directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty

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[77] A-57–A-58, ¶¶ 121, 123, A-62, ¶ 129.

of loyalty by failing to discharge that fiduciary obligation in good faith."[78] Here, the Salix Board with knowledge of Derbyshire's and Logan's misconduct that caused a substantial decline in the Company's value, both of which were subject to a litigation demand, "utterly failed to attempt to obtain the best sale price."[79] The fact that the Salix Board waited until March 25, 2015, after the initial deal with Valeant was announced on February 25, 2015 and just days before the tender offer was to expire, thereby benefitting Valeant to the detriment of Salix stockholders, demonstrates bad faith.[80] Further, and contrary to the Court of Chancery's opinion, the Salix Board had no duty to terminate the equity awards when it did for the benefit of Valeant and could have used it as leverage to negotiate at least some additional consideration for the stockholders short of the entire $39 million benefit.[81] The Board's failure to terminate the awards before agreeing to the Acquisition—or, alternatively, the decision to terminate the equity awards and not seek recompense—constitutes bad faith.[82]

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[78] *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

[79] *Lyondell Chem. Co. v. Ryan*, 970 A.2d 235, 244 (Del. 2009).

[80] *Crescent/Mach I P'rs, L.P. v. Turner*, 846 A.2d 963, 982-83 (Del. Ch. 2000); *see also*, *Strassburger v. Earley*, 752 A.2d 557, 581-82 (Del. Ch. 2000).

[81] A-1076-77 ("Even if they could have negotiated for part or all of the $39 million benefit they allegedly conferred onto Valeant, plaintiffs' allegation that they failed to do so, without more, is not an allegation of disloyalty or bad faith as to the Salix defendants personally.").

[82] The Court of Chancery also questioned, but did not rule upon, the materiality of the value of the equity award termination. A-1077. Here, the Board's own actions—which included calling a special meeting barely a week after agreeing to amend the Merger Agreement and just days before

3. This Is a Direct Claim and Not Derivative

As the Supreme Court stated in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, the proper analysis to distinguish a direct claim from a derivative claim "must be based solely on the following questions: Who suffered the alleged harm -- he corporation or the suing shareholder individually -- and who would receive the benefit of the recovery or other remedy?"[83] Here, there is no doubt that the Salix Board's failure to maximize shareholder value and attain the best price possible for the Salix stockholders in violation of its *Revlon* duties is a direct claim. The termination of the equity awards, which resulted in a reduction of Valeant's aggregate purchase price, should have increased the consideration paid to stockholders. Instead, the Salix Board did Valeant's bidding and succeeded in saving Valeant $39 million without securing any additional consideration for Salix *stockholders*. The claim is direct because it is the Salix stockholders, and not the Company, who would receive the benefit of the recovery in the form of increased consideration for their shares.[84]

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the tender offer was set to expire for the sole purpose of terminating the awards—demonstrates materiality, particularly at the pleadings stage. This conclusion is buttressed by the fact that, in contrast to the Board's action in March 2015, the Board paid a $25 million reverse termination fee in connection with an failed inversion transaction (which was abandoned after anti-inversion rules were announced) despite the existence of a material adverse condition provision that could have alleviated Salix's $25 million obligation. Materiality, at least as inferred from the board's own actions (and certainly on a motion to dismiss), has to fall somewhere between $25 million and $40 million.

[83] 845 A.2d 1031, 1035 (Del. 2004).

[84] Plaintiffs' are not appealing the Court of Chancery's dismissal of its breach of fiduciary duty of loyalty claim based on the Salix board's failure to consider the value of potential derivative

For the foregoing reasons, the Court should vacate and reverse the Court of Chancery's decision with respect to the terminated equity awards.

II. THE COURT OF CHANCERY ERRED IN FINDING THAT THE BOARD MEMBERS DID NOT BREACH THEIR FIDUCIARY DUTIES BY AGREEING TO THE COERCIVE DROP-DOWN PROVISION

A. Question Presented[85]

1. Whether the Step-Down Provision rendered the tender offer coercive.

2. Whether the Director Defendants breached their fiduciary duties by agreeing to the coercive Step-Down Provision.

B. Standard of Review

The Court reviews *de novo* a decision on a motion to dismiss. *See* Section I.B. above.

C. Merits of Argument

1. The Step-Down Provision and the Court of Chancery's Holding

After receiving a topping bid from Endo worth $175 per share, Salix's Board agreed to amend the original Merger Agreement with Valeant in several ways, including by conditionally increasing the Acquisition price from $158 per share to $173 per share.[86] Plaintiffs allege that even the increased consideration was

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claims. A-79, ¶ 193.

[85] A-1078-80.

[86] A-70, ¶ 161.

inadequate.[87] However, pursuant to the Step-Down Provision, if for any reason the Acquisition was not completed by the end of April 7, 2015, Valeant would drop the consideration back down to $158 per share.[88] Plaintiffs alleged that this Step-Down Provision "coerc[ed] Salix stockholders to acquiesce to the unfair Acquisition or risk getting an even more unfair deal."[89]

Defendants and the Court of Chancery focused solely on whether all Salix stockholders—including those who might have tendered before April 8, 2015, those who might have tendered after, and those who did not tender at all—would be treated differently.[90]

This boxed-in approach ignores the teachings and practice of the Delaware courts to view transactions through a lens of practicality and reality. For example, the Court's recent decision in *Singh v. Attenborough* referenced "real-world relevance" and reality-based assumptions concerning stockholder behavior.[91] Further, as this

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[87] A-75–A-81, ¶¶ 177-97

[88] *Id.*

[89] A-71, ¶ 162.

[90] A-245 ("all stockholders stand to receive the *same* form and *same* amount of consideration, regardless of when they elect to tender their shares" (emphases in original)); A-550 ("all stockholders would receive the exact same consideration . . ."); A-1079 ("this tender offer provided the same consideration to all stockholders who tendered . . .").

[91] 2016 Del. LEXIS 276, at *2 (Del. May 6, 2016); *see also Orman v. Cullman*, 794 A.2d 5, 20 n.36 (Del. Ch. 2002) (explaining that the Delaware Supreme Court has rendered certain decisions in light of "practical implications"); *Cypress Assocs., LLC v. Sunnyside Cogeneration Assocs. Project*, 2007 Del. Ch. LEXIS 10 (Del. Ch. Jan. 17, 2007) ("In coming to that conclusion, I am confessedly influenced by the practical implications . . . .").

Court once explained, "our corporate law is not static. It must grow and develop in response to, indeed in anticipation of, evolving concepts and needs."[92] Although Plaintiffs are not aware of any cases that have addressed a step-down provision and certainly not one that arose in a similar context, the draconian measure is akin to other measures that have been recognized as coercive under Delaware law, discussed below. Moreover, neither Defendants nor the Court of Chancery cite any authority—nor could they, because none exists—where a step-down provision like the one here has been upheld as non-coercive. This is a matter of first impression under Delaware law, and Plaintiffs respectfully submit that the Court of Chancery erred in finding the Step-Down Provision to be non-coercive.

2. Delaware's Existing Law on Coercion

Numerous Delaware decisions have defined, described, or recognized coercion in tender offers. As explained in *In re Pure Resources, Inc. Shareholders Litigation*, "coercion is defined in the more traditional sense as a wrongful threat that has the effect of forcing stockholders to tender at the wrong price to avoid an even worse fate later on, a type of coercion I will call structural coercion."[93] *Unocal* found coercion where a measure was "designed to stampede shareholders into tendering at the first tier, even if the price is inadequate, out of fear of what they will receive at the back

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[92] *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 957 (Del. 1985).

[93] *Id.*, 808 A.2d 421, 438 (Del. Ch. 2002).

end of the transaction."[94] In *AC Acquisitions Corp. v. Anderson, Clayton & Co.*, coercion was found where "no rational shareholder could afford not to tender into the Company's self-tender offer."[95] In sum, "as our courts have recognized, a tender offer . . . may be voluntary in appearance and form but involuntary as a matter of reality and substance."[96]

It is similarly well established that there is no single blueprint for coercion, as it has assumed various forms and has been accomplished or planned through various means. In *Unocal*, for example, coercion existed where a would-be hostile acquirer commenced a tender offer for 37% of the target's stock at $54 per share, with non-tendering stockholders receiving debt and equity securities that were purportedly worth $54 per share but, in reality, would be highly subordinated and worth much less.[97] In *Kahn v. U.S. Sugar Corp.*, coercion was present where stockholders had a choice "between tendering at $68 per share or retaining their stock, which after the transaction would no longer be listed on any exchange, would yield no dividends for

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[94] *Unocal*, 493 A.2d at 956.

[95] *Id.*, 519 A.2d 103, 113 (Del. Ch. 1986).

[96] *Eisenberg v. Chicago Milwaukee Corp.*, 537 A.2d 1051, 1056 (Del. Ch. 1987). Other decisions have also defined or described coercion. *See, e.g.*, *In re Siliconix Inc. S'holders Litig.*, 2001 Del. Ch. LEXIS 83, at *58 (Del. Ch. June 19, 2001) ("A tender offer is coercive if the tendering shareholders are wrongfully induced by some act of the defendant to sell their shares for reasons unrelated to the economic merits of the sale. The wrongful acts must influence in some material way the shareholder's decision to tender." (internal citations and quotation marks omitted)).

[97] *Id.*, 493 A.2d at 949, 956.

a minimum of three years, and would represent ownership in a company burdened by substantial debt."[98] In *AC Acquisitions*, coercion was found where, in response to a hostile takeover offer for $56 per share to be followed by a short-form merger at the same price, the target company's board of directors caused the target to commence a self-tender for approximately 65% of the target's stock at less than $60 per share, with the non-tendering shareholders left holding shares of a heavily indebted company, which debt was incurred to finance the self-tender.[99] In *Eisenberg*, the court found coercion in a company's self-tender offer for its preferred stock where the company told preferred stockholders that it "*intend[ed] to request* delisting of the Shares from the NYSE" upon completion of the tender offer.[100]

Regardless of the specific mechanics of any given transaction, these and other decisions yield one central theme—coercion exists where, as alleged here, stockholders don't like the deal they've been offered but nonetheless feel compelled to accept it out of fear about what might happen if they reject it. Indeed, "[t]hose decisions establish what in some quarters is known as a principle . . . ."[101]

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[98] *Id.*, 1985 Del. Ch. LEXIS 522, at *14 (Del. Ch. Dec. 10, 1985).

[99] 519 A.2d at 113.

[100] 537 A.2d at 1062 (emphasis in original).

[101] *Am. Express Co. v. Italian Colors Rest.*, 133 S. Ct. 2304, 2317 (2013) (Kagan, J., dissenting). Of course, the threat of reverting back to the status quo, or something approximating the status quo, does not constitute coercion, and coercion does not exist merely because stockholders may be unable to cherry pick certain advantages of a given transaction while retaining certain aspects of the status quo. *E.g.*, *In re GM (Hughes) S'holders Litig.*, 734 A.2d 611, 621 (Del.

3. The Step-Down Provision Was Actionably Coercive

The Step-Down Provision here meant that any choice on the part of Salix stockholders "[wa]s a charade."[102] No rational shareholder would risk not tendering at $173, because the tender offer price would be reduced to $158 per share if the Acquisition were not completed by April 8, 2015.[103]

Contrary to what the Court of Chancery suggested, the Step-Down Provision did not simply give Salix stockholders the choice of either a deal at $173 per share (which Plaintiffs allege is insufficient) or no deal at all, whereby Salix would continue operating as a standalone entity. Plaintiffs would not advance a coercion argument in such a situation. Quite different, the Step-Down Provision created an in-between, lose-lose scenario in which Salix stockholders would be cashed out for an artificially reduced $158 per share, less even than the already inadequate $173 per share. This middle result is what Salix stockholders "fear[ed],"[104] coercing them to tender before April 8, 2015.

Ch. 1999) (finding no coercion where "GMH stockholders had a free choice between maintaining their current status and taking advantage of the new status offered by the Hughes Transactions"; "you can't have your cake and eat it too"); *AC Acquisitions*, 519 A.2d at 113 ("[I]f all that defendants have done is to create an option for shareholders, then it can hardly be thought to have breached a duty."); *Lieb v. Clark*, 1987 Del. Ch. LEXIS 442, at *12 (Del. Ch. June 1, 1987) ("[A]n offer that is economically 'too good to resist' as compared to the alternative of not tendering, would not, for that reason alone, be actionably coercive." (citation omitted)).

[102] *AC Acquisitions*, 519 A.2d at 113.

[103] Several courts have said

[104] *Unocal*, 493 A.2d at 956.

The mere existence of the Step-Down Provision and the circumstances surrounding the Board's acquiescence to it are telling. Before the Board agreed to amend the Merger Agreement, Endo had submitted an offer to buy the Company valued at $175 per share, which, coincidentally, is the same amount Allergan had offered to pay for Salix before being rebuffed by the Board six months earlier. In response to Endo's topping bid, Valeant increased its offer to $173 per share. This conclusively establishes that Valeant thought Salix was worth at least $173 per share—and, of course, Plaintiffs maintain that Salix was still worth more—yet Valeant insisted upon a transaction structure whereby it could end up paying far less than what Salix was worth even by Valeant's own implicit admission. There is no plausible reason for Valeant to insist upon the Step-Down Provision apart from its desire to coerce stockholders into accepting its offer as quickly as possible.

Accordingly, the structure of the tender offer, as insisted upon by the Valeant Defendants and agreed to by the Director Defendants, was unreasonably coercive.

4. Lack of Disparate Treatment Is Not Dispositive

The Court of Chancery appears to have relied heavily on the fact that the Step-Down Provision applied equally to all Salix stockholders, as if that had talismanic implications.[105] The Court of Chancery also incorrectly stated: "The transaction

[105] A-1080 (explaining that the offer was, "*significantly*, one in which all stockholders still would receive the same consideration." (emphasis added)).

would have been comparable to two separate tender offers, one for $173 per share ending on April [7], 2015, and a separate offer for $158 beginning on April [8]."[106] The latter statement reveals that the Court of Chancery fundamentally misconstrued the Step-Down Provision. Far from being two separate and distinct tender offers, where stockholders at each stage would be free to choose whether to tender their shares, here *all* Salix stockholders were forced to accept an unfair result (getting cashed out for an inadequate $173 per share) or risk getting an even more unfair result (getting cashed out for an further inadequate $158 per share). Indeed, the Step-Down Provision would have uniformly stripped away value if fewer than a majority of Salix shares were tendered by the end of April 7, 2016.

The emphasis on disparate treatment is a distinction without difference, and it reflects infirm temporal logic. Indeed, the foundational coercion cases speak nothing of disparate treatment, at least as far as classifying different stockholders is concerned. Rather, this concept appears to have crept into the vernacular out of two law professors' attempt to provided simplistic clarity.[107] Moreover, Delaware

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[106] *Id.*

[107] Plaintiffs' search for the origin of the "disparate treatment" tagline ended at *Paramount Communications, Inc. v. Time, Inc.*, 571 A.2d 1140 (Del. 1989), where the Court cites an article penned by two academics. *Id.* at 1153 n.17 (quoting Gilson & Kraakman, *Delaware's Intermediate Standard for Defensive Tactics: Is There Substance to Proportionality Review?*, 44 The Business Lawyer, 247, 267 (1989)). Notably, *Paramount* did not purport to pronounce what is, and what isn't, coercion based on this distinction. Moreover, the authors created the artificial distinction in an attempt to include in the definition of coercion "the risk that shareholders will mistakenly accept an underpriced offer because they disbelieve management's representations of intrinsic value." *Id.*

decisional law has consistently focused on how stockholders would act in a subjective manner, at the point in time they are confronted with the tendering decision.[108] In these cases, while there were at least two competing options with varying consequences, the emphasis is on what stockholders are likely to think, and feel, at the point in time they still have the option of choosing.

The same reasoning applies here. In assessing the Step-Down Provision, Salix stockholders would take no comfort knowing that all stockholders would receive the same reduction across the board. Rather, as of March 16, 2015, each individual Salix stockholder was confronted with the prospect of sacrificing long-term growth for $173 per share or sacrificing long-term growth for $158 per share.[109] Feeding the frenzy, of course, is the reality of deal completion and the proliferation of merger arbitrage.[110]

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[108] *See, e.g.*, *Unocal*, 493 A.2d at 956 (discussing shareholders' "tendering at the first tier . . . out of fear of what they will receive at the back end of the transaction"); *Paramount Commc'ns, Inc. v. Time, Inc.*, 571 A.2d 1140, 1152 (Del. 1990) (discussing coercion where "shareholders may be compelled to tender *to avoid being treated adversely* in the second stage of the transaction").

[109] Various cases have stated that coercion is not necessarily about the "economic merits of the sale." *Ivanhoe Partners v. Newmont Mining Corp.*, 533 A.2d 585, 605 (Del. Ch. 1987). Plaintiffs respectfully submit that "economic merits" should not be limitlessly construed. Rather, the better view is that this is merely what was stated further elsewhere in *Ivanhoe*—in the same paragraph even—where the Court of Chancery said that "[a]n offer that is economically too good to resist would not, for that reason alone, be actionably coercive." *Id.* (internal citations and quotations omitted). To hold otherwise would eviscerate the holdings in cases where coercion was found based on, to be sure, "economic merits."

[110] Jessica Hall, "Shareholder activism rarely kills a U.S. merger", Reuters (Feb. 7, 2010), http://www.reuters.com/article/us-dealtalk-activism-idUSTRE61G4C220100217 ("Once a merger offer has been made, shareholders might as well get used to the idea of a deal since history shows investors have limited success rates at launching formal campaigns to block U.S. deals."; "Once a

CONCLUSION

For the reasons set forth above, the Court should reverse the trial court's dismissal of the Second Amended Complaint and remand this matter to the trial court with instructions to reinstate the claims.

Dated: August 2, 2016

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deal has been announced or rumored, shares often migrate into the hands of holders who have a short-term investment horizon and they tend to be very reluctant to block a deal. They may be supportive of trying to get a better price, but most tend to be looking forward to banking their investment and moving on . . . ."); Gaurav Jetley and Xinyu Ji, *The Shrinking Merger Arbitrage Spread: Reasons and Implications*, Financial Analysts Journal, Vol. 66, No. 2 (2010) (discussing, among other things, increase in merger arbitrage, correlation between post-announcement trading volume and deal success).

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