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

APPELLANTS' REPLY BRIEF

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

A. The Step-Down Rendered the Tender Offer Coercive

The Step-Down Provision has no ostensible purpose other than to coerce Salix stockholders into tendering their shares as quickly as possible out of fear of what might have happened if they did not tender. To be sure, Appellants can imagine no other purpose for the Step-Down Provision, and Appellees have repeatedly failed to offer any purpose for Valeant to insist on such a provision. Indeed, Valeant could have encouraged deal certainty through other, less suspect means.[1] Here, however, with Endo's $175 per share offer looming, the Board acceded to a structure that threatened to freeze out Salix stockholders at a plainly inadequate $158 per share simply to secure a deal at a still inadequate $173 per share.

Appellees argue that the step-down provision did not coerce Salix stockholders because all stockholders would "be treated the same as each other regardless of whether or when they tendered."[2] The Chancery Court also focused on disparate treatment as the end-all, be-all consideration. Delaware courts have long criticized the

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[1] In fact, Valeant and Salix accelerated the outside date for completing the Acquisition from August 20, 2015 to May 1, 2015.

[2] Appellees' Ans. Br. at 19, n.13.

use of tender offers that treat stockholders disparately, such as a two-tiered or a front-end-loaded tender offer.[3] Indeed, the parties agree that "[t]he seminal example of a structurally coercive offer is a tender offer that treats similarly situated stockholders differently such as the one in *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985), which presented stockholders with the risk that they would receive junk bonds if they did not tender."[4] As Appellees explain in their brief, "the threat [in that circumstance] is obvious: shareholders may be compelled to tender *to avoid being treated adversely* ...."[5] As explained below, that is precisely what could happen to stockholders that did not tender in this case. But, being treated differently, is not the only basis for this Court to find coercion. The Court has recently acknowledged—

[3] *See, e.g.*, *Paramount Communs., Inc. v. QVC Network, Inc.*, 1993 Del. LEXIS 440, at *3 (Del. Dec. 9, 1993) ("The QVC tender offer and the Viacom tender offer were partial, two-tiered, front-end loaded, and coercive."); *In re Gaylord Container Corp. Shareholders Litig.*, 753 A.2d 462, 478 n.51 (Del. Ch. 2000) ("The Gaylord board was reacting to the traditional threats posed by over-the-transom acquisition offers. In its *Time* and *Unitrin* decisions, the Supreme Court cited with approval a law review article classifying these threats into three categories: opportunity loss (*i.e.*, the risk that stockholders might be deprived by a hostile offer of the superior benefits of management's strategy or a higher offer); structural coercion (*i.e.*, the risk that disparate treatment of stockholders—*e.g.*, through a two-tiered tender offer—might coerce stockholders into tendering for an inadequate price) and substantive coercion (i.e., the risk that stockholders might mistakenly disbelieve management's view that an offer is too low and tender at an inadequate price).").

[4] Appellees' Ans. Br. at 18.

[5] *Id.* (quoting *Air Prods. & Chems., Inc. v. Airgas, Inc.*, 16 A.3d 48, 106 (Del. Ch. 2011)).

and Appellees do not deny—that this Court should evaluate the step-down based on "real-world relevance," and as a result use reality-based assumptions concerning stockholder behavior.[6]

Here, Appellants have demonstrated not only that the Acquisition was coercive in the traditional "disparate treatment" sense, but also in the real-world, reality-based sense. For example, Valeant was permitted to time the Acquisition so that if it did not satisfy the minimum condition by April 8, 2015, but was close, it would be in its best interests to extend the offer for a shorter period of time than it was possible for stockholders to withdraw their tenders, but with enough time that Valeant could potentially get over the minimum condition threshold. More specifically, Section 2 of the first amendment to the Merger Agreement provides that Valeant can "extend the Offer for successive periods of up to ten Business Days each, the length of each such period to be determined by Parent in its sole discretion, in order to permit the satisfaction of such conditions."[7] Thus, Valeant could extend the tender offer for any time period less than 10 days, meaning a one day extension was possible.

Accordingly, stockholders knew that if, by way of example, 49% of Salix's stockholders tendered their shares immediately before the price dropped on April 8, 2015, Valeant was incentivized to extend the tender period for a short period of time

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[6] *Singh v. Attenborough*, 2016 Del. LEXIS 27, at *2 (Del. May 6, 2016).

[7] Appellants' Op. Br. App. at A532.

(e.g., one day) so it could get above the minimum condition threshold, but before stockholders could withdraw their tenders.

Valeant also intentionally ensured that stockholders seeking to withdraw their tenders would find themselves ensnared in a cumbersome and lengthy process.[8] For example, for a withdrawal to be effective it had to be received by the Depositary (as defined in the Offer to Purchase).[9] If certificates evidencing shares to be withdrawn had been delivered or otherwise identified to the Depositary, then, prior to the physical release of such certificates, the serial numbers shown on such certificates had to be submitted to the Depositary and the signature(s) on the notice of withdrawal were required to be guaranteed by an Eligible Institution (as defined in the Offer to Purchase).[10] In short, this process would have taken several days, meaning stockholders that tendered at the higher price could not withdraw their tenders before the tender offer at the lower price expired, if Valeant acted in an economically rational manner.

Moreover, the Acquisition's structure also coerced stockholders because Valeant and Salix ensured stockholders were not adequately informed. More specifically, on March 25, 2015—after the initial tender offer commenced—the

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[8] Appellants' Reply Br. App. at AR20-21

[9] *Id*. at AR03.

[10] *Id*. at AR18.

Company terminated Derbyshire and Logan's unvested equity awards, which were worth approximately $39 million, leaving stockholders only 5 business days to both absorb that information ***and then*** go through the lengthy tender withdrawal process. As explained above, it was nearly impossible as a practical matter for stockholders to absorb the new information ***and then*** withdraw their tenders in such a short period of time.

In addition, not only were Salix stockholders faced with the threat of a reduced offer by Valeant if they did not tender their shares before April 8, 2015, but the Board was forced to continue to recommend the Valeant Acquisition until at least May 1, 2015 (the outside date) rather than removing all the deal protection devices and allowing Endo to proceed with its higher $175 offer immediately after Valeant's higher offer expired. It defies logic that a Board could determine Endo's $175 offer was a superior proposal and yet at the same point in time continue to recommend the $158 offer it just determined was inferior to Endo's offer.

Notably, Appellees cannot point to a single decision inside or outside Delaware holding a step-down provision like the one here was appropriate and not coercive. The fact that the tender offer was coercive results in two conclusions. First, it is well established that stockholders cannot ratify a coercive acquisition. Under *Corwin*, the business judgment rule "applies only to fully informed, ***uncoerced*** stockholder votes[.]"[11] Likewise two decades earlier in *Geier*, the Court explained that "[a]n otherwise valid stockholder vote may be nullified by a showing that the structure or circumstances of the vote were impermissibly coercive."[12] "If the corporate board failed to provide the voters with material information undermining the integrity or financial fairness of the transaction to the vote, no ratification effect will be accorded to the vote and the plaintiffs may press all of their claims."[13]

Moreover, even assuming Appellees are correct that "all stockholders would receive the same form and same amount of consideration, regardless of when they elected to tender their share," that does not end the inquiry.[14] For example, as Appellants explained in their opening brief, in *Kahn v. U.S. Sugar Corp.*, the Court found coercion present even though all stockholders who tendered could receive the same $68 per share price or retain their stock.[15] In any event, Appellees do not respond to Appellants' argument in their opening brief that the disparate treatment argument is a distinction without a difference because Delaware 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 and ignores

[11] *Corwin v. KKR Fin. Holdings LLC*, 125 A.3d 304, 312 (Del. 2015).

[12] *Williams v. Geier*, 671 A.2d 1368, 1382 (Del. 1996).

[13] *Harbor Fin. Partners v. Huizenga*, 751 A.2d 879, 898-99 (Del. Ch. 1999).

[14] Appellees' Ans. Br. at 19.

[15] *Kahn*, 1985 Del. Ch. LEXIS 522, at *14 (De. Ch. Dec. 10, 1985).

stockholder's likely concerns related to the impact of merger arbitrage on deal completion.[16]

B. The Board Members Breached Their Fiduciary Duties by Agreeing to a Coercive Tender Offer

Appellees contend that, even if the Step-Down Provision were coercive, Appellants did not specifically link the coercive structure to a non-exculpated breach.[17] This argument ignores well-established Delaware law: - - Agreeing to a coercive deal structure, especially one like this, *ipso facto* leads to a reasonable inference at the pleading stage that the Board acted disloyally or in bad faith.

Appellees' sole legal support for their position—*KKR* and *Cornerstone*—neither hold nor suggest that a Board could approve a coercive acquisition in good faith. In fact, the Third Circuit has correctly held that coercion is evidence of bad faith.[18] It was further bad faith for the Board to agree to the coercive tender offer because it agreed to maintain its recommendation, even though it knew Endo had already made an indication of interest $2 per share *higher* than Valeant. It is difficult to understand how the Board could continue to recommend an Acquisition that could not garner the support of more than half of Salix's stockholders, especially where

[16] Appellants' Op. Br. at 30-31.

[17] Appellees' Ans. Br. at 21.

[18] *Garvin v. Am. Motor Sales Corp.*, 318 F.2d 518, 519 (3d Cir. 1963) ("Plaintiff concedes that in order to prove bad faith in the failure to renew the franchise, evidence of coercion, intimidation or threats thereof is essential.").

Endo had made an indication of interest more than 10% higher than that offer. Bad faith is especially clear when considering that, with Endo's $175 per share deal still on the table, the Board obligated itself to recommend a deal at $158 per share (*i.e.*, post-step down).

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

A. This Court Should Defer Ruling on the Ratification Issue

The trial court below specifically stated that it was not going to consider whether ratification applied to a tender offer,[19] and thus, was not an issue raised by Appellants on appeal. Notably Chancellor Bouchard rejected this very argument in *Espinoza v. Zuckerberg*, 124 A.3d 47, 61 (Del. Ch. 2015): "defendants suggest that stockholder acts such as tendering shares serve as an example of less formal ratification. This suggestion is unpersuasive, because expressing approval of the sale of a company by tendering shares is not analogous to stockholder ratification." In any event, Appellants submit it would be more efficient to address it in the pending appeal in *In re Volcano Corporation Stockholders Litigation*, No. 372, 2016, where it will be fully briefed. Here, the trial court can decide the ratification issue on remand with the benefit of that ruling. Appellants address the ratification issue herein insofar as this case presents unique circumstances or certain issues were not encompassed by the appellate briefing in *Volcano*.

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[19] Appellants' Op. Br. App. at A1067 ("The first argument raises a question I would want to consider further before making a ruling concerning whether tendering one's shares into a tender offer is the equivalent of formally voting on a merger for purposes of a claim-exclusionary defense.")

B. Even If this Court Takes Ratification Under Consideration, Ratification Does Not Apply Here.

1. Ratification Does Not Apply to Tender Offers

As a threshold matter, until *Volcano*, Delaware law has always required a stockholder ***vote*** for defendants to escape enhanced scrutiny and enjoy the benefit of the presumption of the business judgment rule. For the reasons Appellants stated below,[20] as well as for the reasons set forth in the plaintiffs-appellants' opening brief in the *Volcano* appeal, the Court should adhere to the language it has employed and restrict ratification to situations involving a fully informed stockholder vote.

As argued below, the relevant cases all refer to votes.[21] Here, however, the Acquisition involved a tender offer, not a vote. Appellees, of course, could have structured the Acquisition to include a vote, but they chose not to. Rather, favoring speed, Appellees opted for a tender offer.[22] Appellees attempted to equate votes and

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[20] *Id*. at A585-87

[21] *E.g.*, *Corwin*, 125 A.3d at, at *10 ("[W]hen a transaction not subject to the entire fairness standard is approved by a fully informed, uncoerced vote of the disinterested stockholders, the business judgment rule applies."); *In re Wheelabrator Technologies, Inc. S'holders Litig.*, 663 A.2d 1194 (Del. Ch. 1995) (referring to a stockholder vote); *Solomon v. Armstrong*, 747 A.2d 1098, 1117 (Del. Ch. 1999) (same); *In re Santa Fe Pac. Corp. S'holder Litig.*, 669 A.2d 59, 67-68 (Del. 1995) (same); *Williams v. Geier*, 671 A.2d 1368, 1379 (Del. 1996) (same).

[22] In amending the Merger Agreement, Appellees further demonstrated their need for speed by accelerating the outside date for completing the Acquisition from August 20, 2015 to May 1, 2015. Appellants' Op. Br. App. at A70.

tender offers by citing *In re Orchid Cellmark Inc. Shareholder Litigation*,[23] and *Matador Capital Management Corp. v. BRC Holdings*,[24] but these two opinions involved very different situations and do not even remotely suggest that a successful tender affects the standard of review. *Orchid Cellmark* involved a preliminary injunction motion in which Vice Chancellor Noble noted only that "[t]endering . . . is a substitute for shareholder vote" in the context of discussing "the balancing of the equities."[25] There was no discussion of the applicable standard of review. In *Matador Capital*, Vice Chancellor Lamb stated, and solely in response to the defendants' arguments to the contrary, that directors owe the same duties of disclosure in tender offer documents as they do in proxy statements.[26] This, too, is unavailing.

Here, 139,294,447 Salix shares—representing 217% of the Company's total outstanding and issued shares—traded hands from when the Acquisition was announced to when it closed.

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[23] *Id*. at A230 (citing C.A. No. 6373-VCN, 2011 Del. Ch. LEXIS 75 (Del. Ch. May 12, 2011)).

[24] *Id*. (citing 729 A.2d 280 (Del. Ch. 1998)).

[25] 2011 Del. Ch. LEXIS 75, at *37.

[26] 729 A.2d at 294-95.

2. Even If *Corwin* Applies to Tender Offers, Ratification Does Not Apply Here Because There was Inadequate Disclosure

Under *Corwin*, ratification only applies where there is a "*fully informed, uncoerced vote* of the disinterested stockholders . . . ."[27] As explained above, the Step-Down Provision rendered the Acquisition coercive, thus precluding ratification. Moreover, as alleged and argued below, the 14D-9 and amendments thereto failed to disclose material information, thus further precluding ratification.[28]

Appellees state in their Answering Brief that Appellants abandoned their disclosure arguments,[29] but this position confuses the issue of whether there was adequate disclosure with whether a plaintiff has alleged a disclosure *claim*. Appellants initially pursued disclosure-based claims for breach of fiduciary,[30] but the Court of Chancery rejected these claims either for lack of materiality (in the case of the BDSI relationship) on the grounds that Appellants could not at the pleadings stage tie any of their remaining disclosure issues to bad faith or disloyalty and therefore did not state a claim that was not exculpated by Salix's 102(b)(7) exculpatory provision.[31] However, during oral argument, Appellants and the Court of Chancery specifically

[27] *Corwin*, 125 A.3d at 308.

[28] As before, the Court of Chancery declined to rule on all but one of Appellants' disclosure allegations, so this issue may not be ripe for appellate review.

[29] Appellees Ans. Br. at 23.

[30] Appellants' Op. Br. App. at A84-93.

[31] *Id*. at A1082-83.

parsed the two, recognizing that the absence of any disclosure-related breach of fiduciary duty does not automatically mean that there was adequate disclosure for ratification purposes.[32] Although Appellants are not challenging the Chancery Court's dismissal of their disclosure claims, Appellants have always maintained that the disclosure here were inadequate.

In contrast, for a plaintiff to demonstrate that a stockholder vote was not fully informed, it must merely show a material disclosure deficiency. For a misleading fact or omission to be "material," there must be a substantial likelihood that a reasonable investor would have viewed the disclosure of the fact as having significantly altered the "total mix" of information made available.[33] The standard is whether the fact would have been relevant to investors' decisions, *not* whether it necessarily would have changed investors' decisions regarding the transaction.[34] The materiality inquiry is a "mixed question of law and fact,"[35] and "[t]he 'total mix' of information available varies on a fact-specific and case-by-case basis." Further, "[w]hen a document ventures into certain subjects, it must do so in a manner that is materially complete

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[32] Appellees' Ans. Br. App. at B120-21.

[33] *TSC Indus., Inc. v. Northway*, 426 U.S. 438, 449 (1976).

[34] *See Shell Petroleum, Inc. v. Smith*, 606 A.2d 112, 114 (Del. 1992); *Barkan v. Amsted Indus., Inc.*, 567 A.2d 1279, 1289 (Del. 1989).

[35] *TSC Indus.*, 426 U.S. at 450.

and unbiased by the omission of material facts."[36] Any doubts concerning whether a given misrepresentation or omission is material should be "resolv[ed] in favor of those the statute is designed to protect," *i.e.*, the shareholders.[37]

Appellants alleged and argued below that the Board failed to disclose material information concerning, among other things, Salix's financial projections.[38] Management's financial projections are among the most important information a shareholder can have when evaluating whether to tender.[39] Financial projections are especially important given the standard reliance on the discounted cash flow ("DCF") analysis, which uses projections as its key input.[40]

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[36] *In re Pure Res. S'holders Litig.*, 808 A.2d 421, 448 (Del. Ch. 2002).

[37] *Id.* at 448 (citing *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 385 (1970)).

[38] Appellants' Op. Br. App. at A91-92; A613-17.

[39] *See In re Emerging Communs., Inc. S'holders Litig.*, C.A. No. 16415, 2004 Del. Ch. LEXIS 70, at *134 (Del. Ch. May 3, 2004) (projections are "highly material" because knowledge of the projections "would have enabled the shareholders to understand [the company's] intrinsic worth and the extent of the market's undervaluation of their company"); *In re PNB Holding Co. S'holders Litig.*, C.A. No. 28-N, 2006 Del. Ch. LEXIS 158, at *58 (Del. Ch. Aug. 18, 2006) ("[R]eliable management projections of the company's future prospects are of obvious materiality to the electorate.").

[40] *See Laborers Local 235 Benefit Funds v. Starent Networks, Corp.*, No. 5002-CC, 2009 Del. Ch. LEXIS 210, at *2 (Del. Ch. Nov. 18, 2009) ("[T]he discounted cash flow analysis [is] arguably the most important valuation metric" for a company.); *In re Toys "R" Us, Inc. S'holder Litig.*, 877 A.2d 975, 1013 (Del. Ch. 2005) ("[A] DCF model . . . is the model most consistent with what the Company's stockholders would receive in an appraisal.").

Salix's management created product-level projections through 2029 for 10 different "Current Products," 5 different "Pipeline" candidates, and 7 different "Other Drugs."[41] But these financial projections were never disclosed.[42] Rather, the 14D-9 disclosed only the Company's risk-adjusted product-level projections and certain resulting enterprise-level projections.[43] This selective disclosure precluded the Company's stockholders from being able to consider Salix's unvarnished long-term prospects in relation to the Acquisition.

Companies often risk-adjust aspects of their financial projections to reflect the probability that a given drug candidate will not receive the requisite approval and, thus, will not be commercialized for the intended purposes. As recognized in *In re Celera Corp. Shareholder Litigation*,[44] risk-adjusting the financial projections of a pharmaceutical company is a complicated matter and can have a huge impact on valuation.[45] Opinions also vary widely on what may be an appropriate assumption

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[41] Appellants' Op. Br. App. at A614.

[42] *Id*.

[43] *Id*. at A615.

[44] C.A. No. 6304-VCP, 2012 Del. Ch. LEXIS 66 (Del. Ch. Mar. 23, 2012), *rev'd in part on other grounds*, 59 A.3d 418 (Del. 2012).

[45] *Id*., 2012 Del. Ch. LEXIS 66, at *15-16 (explaining that the target's financial advisor misapplied probability adjustments and that the errors undervalued the company by 8-11%).

regarding a drug candidate's success rate, and these assumptions further differ based on the type of drug candidate and stage of development.[46]

Given the broad range of probability assumptions that arguably could be used to adjust projections for risk, management is given extraordinary discretion to reverse engineer figures to support an acquisition at nearly any price.[47] As such, the only way to protect against overreaching and ensure that stockholders are adequately informed about a company's true financial prospects (and not merely those viewed through a contextually optimistic or pessimistic lens) is to require disclosure of, at a minimum, the unadjusted projections and probabilities used to make the risk adjustments for the 5 pipeline drug candidates.

Disclosure was also required because of the extent of management's risk adjustments. Specifically, whereas adjustments are normally made only with

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[46] *Contrast* Jeffrey J. Stewart, *Biotechnology Valuations for the 21st Century*, Milken Institute Policy Brief (April 2002) (reporting the following probabilities of a drug reaching market from a given stage of development: phase I (20%); phase II (30%); phase III (67%); final application for FDA approval (81%)), Appellants' Op. Br. App. at A642-56; Jeremy Gelber, *Monitoring the Process of Clinical Trials* (July 14, 2007) (observing cumulative Phase I, II, and III completion percentage as 80.7%, 57.7%, and 56.7%, respectively), *Id*. at A658-84; *see also* BIO/BioMedTracker Clinical Success Rates Study (Feb. 15, 2011) (showing gross disparity in probabilities), *Id*. at A686-97.

[47] *See* Appellants' Op. Br. App. at A92 ("The absence of information provided to stockholders gave Salix management carte blanche to skew the numbers as was necessary to cement a deal.").

unapproved drug candidates in the pipeline, as was done here,[48] Salix's management also risk-adjusted projected revenue as well as its Current Products.[49] This unorthodox adjustment makes little sense and supports an inference that the adjustments were not made in good faith to enable Centerview and J.P. Morgan to support the Acquisition at an unfair price. In any event, the 14D-9 was materially inadequate.

The 14D-9 also failed to disclose how either Centerview or J.P. Morgan treated stock-based compensation in deriving unlevered free cash flows from the Company's financial projections (*i.e.*, whether it was treated as a cash or non-cash expense). This information is material because treatment of stock-based compensation is a central question in DCF valuations.[50]

Disclosure of the treatment of stock-based compensation is also imperative

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[48] Appellants' Op. Br. App. at A319 ("The Company has risk adjusted the Management Projections by applying a probability of success adjustment to products that have not yet gained regulatory approval, which varies based on their current phase of development, consistent with industry practice.").

[49] *Id.* ("The Company's senior management also prepared risk-adjusted forecasts for each of the Company's currently marketed products and products in development through 2029.").

[50] *See Merion Capital, L.P. v. 3M Cogent, Inc.*, C.A. No. 6247-VCP, 2013 Del. Ch. LEXIS 172, at *43-44 (Del. Ch. July 8, 2013), *judgment entered sub nom. Merion Capital, L.P. v. 3M Cogent, Inc.* (Del. Ch. July 23, 2013) ("Questions about the treatment of SBC often arise in this Court when fairness opinions fail to disclose whether the individual or entity rendering the opinion treated SBC as a non-cash expense in its DCF analysis.").

because Salix's projections were not based on GAAP.[51] This distinction is important because the 14D-9 specifically discloses that for purposes of calculating EBTIDA management treated stock-based compensation as a cash expenses consistent with GAAP.[52] However, the Recommendation Statement indicates that Centerview and "calculated" the projected "unlevered free cash flow represents unlevered net operating profit before interest and after tax, adjusted for depreciation and amortization, capital expenditures, changes in net working capital, and certain other one-time cash flow items as applicable." Recommendation Statement at 39. Because neither banker used GAAP projections and did not state whether it made an adjustment to the cash flows to treat stock-based compensation as a cash or non-cash expense, stockholders cannot determine how a court may analyze the transaction in an appraisal proceeding where it is far from certain whether stock-based compensation will be treated as a cash or non-cash expense.

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[51] Appellants' Op. Br. App. at A320 ("The Management Projections were not prepared with a view toward public disclosure, compliance with U.S. GAAP.").

[52] Statement of Financial Accounting Standards No. 123 (revised 2004) ("This Statement requires that the cost resulting from all share-based payment transactions be recognized in the financial statements."); Financial Accounting Standards Board, Accounting Standards Codification § 718-10-25-2 (requiring entities to "recognize the services received in a share-based payment transaction with an employee as services are received.").

Here, however, stockholders have been left in the dark regarding a critical valuation step.

As briefed and argued below, the 14D-9 was deficient because it also failed to disclose material information regarding the financial advisors' analyses. Appellants respectfully refer the Court to the briefing and argument on those points.[53]

C. Appellants Adequately Pled a Non-Exculpated Breach Against the Board for Terminating the Equity Awards Without Conferring Value to Salix Stockholders

1. Appellees Inappropriately Contest the Facts

Appellants claim both below and on appeal that the Salix Appellees breached their fiduciary duties by terminating the $39 million in unvested equity awards subsequent to entering the Merger Agreement, thereby reducing the cost to Valeant without a corresponding increase in the price per share paid to Salix shareholders. Indeed, the Board's eleventh hour action decreased the aggregate value of the Acquisition despite there being no corresponding diminution in the value of the Company. It is this act—giving the buyer, which should stand at arm's length until the Acquisition closed a $39 million discount without getting anything in exchange—which triggered a non-exculpated breach of fiduciary duty.

[53] Appellants' Op. Br. App. at A622-26.

At the outset, Appellees argue the facts, which is inappropriate on a motion to dismiss. Specifically, Appellees' supposition about the market's recognition of Logan's and Derbyshire's severance agreements and their invocation of *Primedia* incorrectly assumes that Valeant could have recouped the $39 million post-close.[54] To the contrary, with respect to the $39 million equity award termination, Appellants alleged in their Complaint:

> Indeed, had Logan's and Derbyshire's equity awards vested and paid out (which would have happened by operation of the Merger Agreement), Valeant would have been unable to retroactively claw back any money related to the equity awards at issue. Accordingly, Valeant needed the Board to terminate the unvested equity awards prior to the expiration of the Tender Offer, which the Board gladly did on or about March 24, 2015.[55]

2. Appellants Have Stated A Direct Rather Than Derivative Claim Related To The Board's Termination Of The $39 Million In Unvested Equity Awards

Appellees also mistakenly try to frame the $39 million as inseparable from any potential derivative claims against the Board. It is the timing of the Board's actions that is at issue on appeal not whether the Board adequately valued any purported derivative claims.[56]

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[54] Appellees' Ans. Br. at 29-33 (suggesting that "Valeant was not only aware of the potential claims but would have pursued them").

[55] Appellants' Op. Br. App. at A80.

[56] Appellants made it crystal clear in their opening papers that it was not appealing the issue of valuing any derivative claims. *See* Appellants' Op. Br. at pp. 22-23, n.84.

The Supreme Court held in *Tooley v. Donaldson, Lufkin & Jenrette, Inc.*, that the proper analysis in distinguishing direct from derivative claims must be based on "[w]ho suffered the alleged harm the corporation or the suing stockholder individually and who would receive the benefit of the recovery or other remedy?"[57] The termination of the equity awards, resulting in a reduced aggregate purchase price to Valeant of $39 million, should have inured to the benefit of Salix stockholders in the form of increased compensation in the aggregate amount of $39 million and it is the Appellees' failure to terminate the awards in a timely fashion that caused the harm directly to the stockholders. With the Company in *Revlon* mode since November 2014, the directors failure to terminate the unvested equity awards in a timely manner and prior to entering any agreement to sell the Company taints the process, rendering both the merger and price unfair.

Recent case law supports Appellants' position. The Chancery Court in *In re Riverstone Nat'l, Inc. Stockholder Litig.,* held that where the ex-stockholders bring a claim related to the fairness of the merger, as is the case here, the action is direct, not derivative.[58] The court in *Riverstone* distinguished the *Primedia* case, where defendants argued that the claims were derivative and therefore extinguished by the

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[57] 845 A.2d 1031,1035 (Del. 2004).

[58] C.A. No. 9796-VCG, 2016 Del. Ch. LEXIS 111 at *26-27 (Del. Ch. July 28, 2016).

merger and plaintiffs hotly contested that characterization, arguing that they had standing under the court's analysis in *Primedia* based on defendants' failure to obtain value for the derivative claims.[59] The Chancery Court in *Riverstone* rejected defendants' argument that the claims were derivative and not direct:

> The Defendants first try to distinguish the plaintiffs' Complaint as a disguised pursuit of the Usurpation Claims, which were derivative in nature and thus extinguished by the Merger. The plaintiffs hotly contest that characterization, arguing that they have standing under this Courts analysis in *Primedia*. (Footnote omitted). I need not consider that issue further here. *Primedia* involved an existing derivative suit against a corporate controller, which was extinguished by merger. The plaintiff ex-stockholders then sought to pursue the matter as a direct action, alleging that no value had been negotiated for the litigation asset, and that the acquirer did not intend to pursue it. The question followed whether the ex-stockholders had standing to pursue that claim directly, in challenge to the merger.
>
> Here, by contrast, the ex-stockholders bring a direct claim: that the merger was unfair. They undoubtedly have standing to do so. (Footnote omitted).[60]

Here, the facts are even more compelling. Although Appellants initially pled that the Board failed to account for the value of potential derivative claims arising out of the inventory problems, Appellants expressly abandoned those claims on appeal. There is no derivative claim pending and therefore, whether Valeant would pursue

[59] *In re Primedia, Inc. Shareholders Litigation*, 67 A.2d 455 (Del. Ch. 2013)

[60] 2016 Del. Ch. LEXIS 111, at *26-27.

such a claim is irrelevant rendering the three part test in *Primedia* inapplicable.[61] The bad faith claim, which is valued at $39 million, arises solely out of the Boards inexplicable decision to reach an unfair deal *and then* give a $39 million discount to Valeant just days before the Acquisition was scheduled to close. Indeed, the issue is the timing of the Board's action, which goes directly to the fairness of the merger itself. Accordingly, Appellants have pled a direct claim against the Salix Appellees.

Further, to the extent that *Primedia* does apply, the Board's decision to terminate the unvested equity awards was based on a finding that Derbyshire and Logan engaged in conduct that caused intentional harm to the company per the standard set forth in their respective severance agreements. Such a finding clearly forms the basis of a valid derivative claim that would undoubtedly pass muster on a motion to dismiss. Moreover, the value of that derivative claim was far in excess of the $39 million in unvested equity awards that were terminated by the Salix Appellees and clearly material. The value of the Company prior to disclosure of Derbyshire and Logan's misconduct was approximately $205 per share as illustrated

[61] The argument that Appellants fail the third part of the *Primedia* test because they cannot show that Valeant would not pursued the derivative claims based on Appellants' allegation that Valeant muscled the Board into terminating the unvested equity awards is misguided. Once the shares were tendered and the deal closed, there would have been no unvested equity awards to terminate and pursuing a derivative claim would have encountered a whole host of other obstacles. At no time during the merger discussions were the derivative claims even mentioned.

by Allergen's offer to purchase Salix on August 20, 2014.[62] After the disclosure of the company's bloated inventory levels due to Derbyshire and Logan's intentional misconduct was revealed publicly, Salix was ultimately sold to Valeant for $173 per share, over $30 per share less, clearly material under the circumstances here and if Valeant intended to pursue those claims it was required to disclose its intention given the added value that such claims had on the deal, information that stockholders would have needed to know in determining whether to tender their shares or not.

3. Appellants Have Stated A Breach Of Fiduciary Duty Claim Related To The $39 Million In Unvested Equity Awards

By the time the merger agreement was signed on February 20, 2015, the Board: (i) already investigated the inventory issue; (ii) parted ways with and entered into the severance agreements with Derbyshire and Logan, both of which contained identical language that in the event the board determines that either of them "intentionally engaged in wrongdoing that has resulted, or would reasonably be expected to result, in material harm to [Salix]" then any outstanding equity-based awards held by Derbyshire or Logan that are "unvested or otherwise remain subject to restriction will without notice immediately terminate and [Derbyshire/Logan] will not receive any shares of stock or other consideration therefor;" and (iii) received a litigation demand from Plaintiff Feinstein on January 8, 2015, and responded to that demand on January

[62] Appellants' Op. Br. App. at A37-38.

19, 2015, confirming that it would be addressed and considered by Salix's Board at an upcoming Board meeting.[63] Thus, by January 8, 2016, at the latest and as early as December 30, 2014, when Logan abruptly retired, the Board had a duty to act pursuant to its *Revlon* duties and terminate the $39 million in unvested equity awards in order that any potential sale not include the value of the unvested equity awards. This would have had the effect of lowering the amount of shares that the aggregate purchase price would ultimately be distributed amongst and increased the consideration per share to stockholders. The Salix Appellees knew they had a duty to act based on the negotiation of the unvested equity termination language in the severance agreements they themselves negotiated and the litigation demand received from Plaintiff Feinstein. The failure to terminate the unvested equity awards with the knowledge that the Company was for sale indisputably amounts to bad faith and certainly could not have been done in compliance with the Board's duties to maximize stockholder value under *Revlon*.

To make matters even worse, on January 28, 2015, three weeks prior to inking the Valeant deal, the Salix Appellees caused the Company to issue a restatement: (i) concerning non-inventory items that were used to manipulate the recognition of revenues; (ii) artificially increase earnings; (iii) mislead the investing public about its

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[63] *Id*. at A42-44; A53-54; A57-58; A62.

cash flow from operations; as well as (iv) the company's credit worthiness.[64] If any doubt on the Board's part remained as to the proper course of action to take regarding the termination of the unvested equity awards, the discovery and announcement of the restatement should have alleviated any hesitation on the part of the Salix Appellees' to act to immediately terminate the unvested equity awards. This failure to act only buttresses Appellants' allegations of bad faith. Accordingly, the Salix Appellees breached their fiduciary duty by delaying the termination of the $39 million in unvested equity awards until after the deal with Valeant had been entered into.

CONCLUSION

For the reasons stated herein, the Court should reverse the Court of Chancery's decision and reinstate Appellants' claims against Appellees.

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[64] *Id*. at A62-63.

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