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IN THE SUPREME COURT OF THE STATE OF DELAWARE

ARTHUR FLOOD, individually and on behalf of all others similarly situated, Plaintiff- Below, Appellant, v. SYNUTRA INTERNATIONAL, INC., LIANG ZHANG, JINRONG CHEN, LEI LIN, YALIN WU, XIUNG MENG, BEAMS POWER MERGER SUB LIMITED, and HOULIHAN LOKEY CAPITAL, INC., Defendants-Below, Appellees.	Court Below: Court of Chancery of The State of Delaware C.A. No. 2017-0032-VCL (Consolidated)

APPELLANT'S CORRECTED REPLY BRIEF

Dated: May 31, 2018

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases

INTRODUCTION

Ab initio means "from the beginning." The dual protections articulated by this Court in *M&F Worldwide*—special committee approval and a majority of the minority vote—were not present in the Buyer Group's Initial Offer Letter,[1] and thus were not in place *ab initio*. *Kahn v. M&F Worldwide Corp.*, 88 A.3d 635, 644 (Del. 2014) ("*M&F Worldwide*"). Negotiations commenced with that Initial Offer Letter, and the Buyer Group did not include the dual protections as terms of its offer until over two weeks after the Initial Offer Letter. During that interim period, Zhang and the Buyer Group had the opportunity to disable, but did not. Moreover, several events occurred before the Buyer Group agreed to the dual protections, including Zhang's appointment of his chosen "independent" director to the Board, the Buyer Group's engagement of the Board's outside counsel, that counsel's subsequent advice to the Board on its fiduciary duties in connection with the Buyout, and the negotiation of a conflict waiver necessary for this rearrangement of counsel. The trial court, drawing inferences in favor of the Plaintiff, should have found that the self-disabling by the controller in the spirit of *M&F Worldwide* did not occur until after these substantive events in connection with the negotiation of the Buyout. Thus, the trial court should have concluded that the *M&F Worldwide* protections were not in place *ab initio*, the entire fairness standard of

[1] Capitalized terms not defined herein have the same meanings as in the Appellant's Opening Brief.

review should have been applied, and the motion to dismiss should have been denied.

Moreover, the motion to dismiss should have been denied because Plaintiff pled specific allegations demonstrating that the Special Committee failed to exercise due care in negotiating a fair price. Taking all reasonable inferences in Plaintiff's favor, as the trial court was obligated to do, Plaintiff demonstrated that the Special Committee was grossly negligent in failing to negotiate a fair price. Accordingly, entire fairness should have remained the standard of review, and the motion to dismiss should have been denied.

ARGUMENT

I. THE DUAL PROTECTIONS WERE NOT IN PLACE *AB INITIO*

A. *Ab Initio* Should Be Interpreted Strictly

Ab initio literally means from the outset, the start. If the *ab initio* requirements were opened to a subjective interpretation of when negotiations substantively began, a controller could place its imprint on the process and exert control without disabling itself for a significant period of time, while keeping the transaction subject to only the business judgment standard of review. Creating such potential for abuse – and for interminable litigation arising from every controller-buyer transaction -- was not this Court's intended precedent in *M&F Worldwide*. That is why this Court made it clear that these requirements had to be in place from the outset, and specifically used the phrase "*ab initio*."

Here, negotiations began when Zhang sent his Initial Offer Letter on January 14, 2016. (A151). However, if, as Defendants argue, the point at which negotiations begin was to be treated as a subjective finding of fact, then the negotiations arguably did not begin until the Special Committee countered Zhang's initial price in September, eight months after the Initial Offer Letter. (A161-62). This illustrates the potential for abuse inherent in the trial court's decision.

Defendants' reliance on this Court's decision in *Swomley* is misplaced. Answering Br. at 18-20. The factual circumstances that led this Court to affirm the Chancery Court's ruling were entirely distinguishable. The initial offer in

Swomley was made at a board meeting when the controller presented the other members of the board with a term sheet for a proposed squeeze out. *Swomley v. Schlecht, et al.*, No. 180, 2015, Appellants' Op. Br. at 10. While the term sheet indicated that the majority vote of the unaffiliated stockholders was conditioned on the approval by minority holders, it noted "[w]hether this condition can be waived remains to be determined." *Id.* Thus, it cannot be said that the controller had not contemplated this condition.

At the same meeting where the controller presented the term sheet, the board, including the controller's CEO, Schlecht, definitively resolved that the majority vote of unaffiliated stockholders was a non-waivable condition from that day forward. *Id*. at 10-11. The presentation of the initial term sheet, which was not concrete regarding this condition, was **immediately** superseded by the board resolution ensuring the presence of both dual protections.

In contrast, here, over two weeks passed after Zhang submitted his Initial Offer Letter before the dual protections were in place. Additionally, Zhang participated in the intervening meeting, wherein the Special Committee was created, but abstained from voting on its creation. He had the opportunity to self-disable, and did not. The facts here are notably distinguishable from *Swomley* and demonstrate conclusively that the dual protections were not present *ab initio*.

Indeed, it was only by improperly drawing factual inferences in favor of Defendants that the trial court was able to conclude that that the protections were in place *ab initio*. *See* (Or. ¶ 7f.) (discussing the "arguably substantive" events that occurred after the Initial Offer Letter, and stating that it "would have been preferable, both optically and substantively, for the Buyer Group to retain its own counsel").

In response, Defendants argue that the *ab initio* requirement should not be applied strictly or, to use their term, rigidly. Answering Br. at 20. This argument is not supported by the case law. First, as noted, this Court used the precise phrase *ab initio* in *M&F Worldwide*, rather than potential subjective alternatives like, "before substantive negotiations" or "early in the process." *M&F Worldwide*, 88 A.3d at 645. Rather, the Court imposed a stark, bright-line requirement: *ab initio*. *Id*.

As the Court of Chancery, per Vice Chancellor Slights, has held:

> Of particular relevance here, in the seminal *Kahn v. M & F Worldwide Corp.*, our Supreme Court synthesized decades of jurisprudence to lay out the road map by which a controlling stockholder's buyout of its subsidiary in a negotiated merger will earn the controller the maximum deference our law allows, even at the pleadings-stage. Specifically, the court explained that if the relevant constituencies involved in the transaction ***precisely implement*** designated measures intended to replicate arms-length bargaining, then the standard by which the alleged conflicted transaction will be reviewed, even at the pleadings stage, will be the business judgment rule. ***If they deviate from the detailed road map laid out by the court, however, then the path to pleadings-stage deference will be closed and the default***

standard of review, entire fairness, will govern any motion to dismiss the complaint.

In re Martha Stewart Living Omnimedia, Inc. Stockholder Litig., No. CV 11202-VCS, 2017 WL 3568089, at *1 (Del. Ch. Aug. 18, 2017).

Indeed, the plain language of *M&F Worldwide,* states that the controlling stockholder must know "from inception" that the dual protections are in place. 88 A.3d at 644. That was not the case here, where the controller did not opt to include those protections until more than two weeks after the Initial Offer Letter. Two weeks later is not *ab initio*; it is not from inception. The standard set forth by this Court in *M&F Worldwide* was strict, and it should be treated accordingly. Permitting the Chancery Court's ruling to stand would erode the clear standard set forth by this Court, and would encourage abuse and an inevitable proliferation of needless litigation.

B. The Events After The Initial Offer Letter But Before Zhang Established The Dual Protections Lead To The Inference That Zhang Did Not Self-Disable

Defendants make much of the fact that the Special Committee met the day after receiving the Buyer Group's second letter indicating the Buyout would not proceed unless the dual protections were in place. Answering Br. at 22. Yet the crux of Plaintiff's allegations pertains to the influence of Zhang on the process in the intervening period between the first and second letter.

First, and in contrast to events in *Swomley*, the full Synutra Board held a meeting one week after Zhang delivered the Initial Offer Letter, and Zhang abstained from voting upon the Board resolution to form a Special Committee to consider the Buyout. *Cf. Swomley*, App. Op. Br. at 10-11 (noting that the controlling stockholder acknowledged and insisted upon the special conditions necessary to protect minority stockholders). Zhang's failure to support this resolution supports an inference that he did not consent or agree that his proposal would not proceed except upon the approval of an independent special committee. While ultimately he did later agree to have this protection included, he did not intend it originally, as evidenced by his abstention. Even after a discussion of the directors' fiduciary duties in considering and evaluating the Initial Offer Letter with Davis Polk, Zhang did not commit to a requirement of special committee approval, nor the approval by a majority of the minority. (A064.)

Second, in that same meeting, Zhang recommended a potential candidate to the Board who had been referred "by a personal friend." (Or. ¶ 9d quoting Proxy at 20.) While the Proxy indicates that Wu was "well-qualified," the extent of his ties and loyalties to Zhang is unknown. Nevertheless, at this meeting, one week after submitting the Initial Offer Letter, Zhang recommended Wu as an independent director to the Board, and Wu was appointed to the Special Committee. One can hardly characterize Zhang as self-disabled when he unilaterally added a member to the Board (and, by extension, to the Special Committee, on the very day it was formed).

Third, the Proxy states that the Board discussed the terms of the Initial Offer Letter at the January 21, 2016 Board meeting. While the Proxy self-servingly claims that no substantive discussions took place, this is **<u>Defendants'</u>** version of events. The trial court impermissibly drew inferences in Defendants' favor in concluding that this line in the Proxy established at such an early juncture that nothing of consequence took place at that meeting. *See Allied Capital Corp. v. GC-Sun Holdings, L.P.*, 910 A.2d 1020, 1030 (Del. Ch. 2006) (holding that the court must accept reasonable inferences in plaintiff's favor on a motion to dismiss).

Finally, with respect to the waiver of Davis Polk's conflict of interest on behalf of the Company, Defendants' arguments miss the mark. At the time of this meeting, the Buyer Group had already retained Davis Polk as legal counsel. Davis Polk then advised the Board at the January 21, 2016 meeting, including those individuals appointed to the Special Committee, as to their fiduciary duties in considering and evaluating the Initial Offer Letter. Hence, it is clear that the **<u>controller's counsel provided advice to the Special Committee members</u>**, and thus arguably tainted the Special Committee's process. Moreover, it is undisputed that the conflict waiver was negotiated in the intervening period – a fact that the trial court noted was an "arguably substantive event." Or. ¶ 7(f). But this was an inarguably substantive event as it impeded the ability of the Special Committee to select its own counsel as the Buyer Group preemptively captured the Board's preferred outside counsel. *See M&F Worldwide*, 88 A.3d at 645 (holding that the special committee must be able to freely select its own advisors in order to apply the business judgment standard). Nevertheless, the trial court drew inferences against Plaintiff and in favor of Defendants in finding that the dual protections required by *M&F Worldwide* were in place *ab initio*. Or. ¶ 7(g).

There was simply too much interaction, intermingling, and overlapping between the Buyer Group and the Board during the time between the Initial Offer Letter and the Buyer Group's second letter for the trial court to properly conclude, as a matter of law, that the dual *M&F Worldwide* protections had been properly imposed *ab initio*. As such, entire fairness should have remained the standard of review, and the motion to dismiss should have been denied.

II. THE SPECIAL COMMITTEE'S FAILURE TO NEGOTIATE A FAIR PRICE DEMONSTRATES THEIR GROSS NEGLIGENCE

Plaintiff does not argue, as Defendants assert, that merely pleading that the Buyout price was unfair is sufficient to survive a motion to dismiss. Answering Br. at 26. Rather, Plaintiff argues that, as in *M&F Worldwide*, these particular allegations regarding the insufficiency of the Buyout price demonstrate the gross negligence of the Special Committee. Opening Br. at 23-25. Moreover, Defendants mischaracterize Plaintiff's allegations as "merely conclusory," when Plaintiff has actually pled particularized factual allegations strikingly similar those facts in *M&F Worldwide* that the Court indicated would have justified a denial of a motion to dismiss. These facts, when viewed together, should have been held to state a claim for breach of fiduciary duty of care, and should have thereby precluded a shift of the standard of review from entire fairness to business judgment.

A. The Special Committee Repeatedly Acceded to Lowered Financial Projections Based On Short-Term, Actual Results

Defendants argue that the Company repeatedly underperformed and that management updated projections to take into account the Company's performance over three fiscal quarters. Answering Br. at 27-28. These explanations for the lowered projections belie the reality. Management was not simply adjusting its projections to reflect actual results; it was systematically lowering projections not just for the current fiscal year, but for the subsequent three years. Management was using short term results as a basis for lowering projections in the outer years with no justification for doing so.

Specifically, the reasons given for the lowering of the May Projections were as follows: "(i) the Company had materially failed to meet its revenue and net income forecasts for four consecutive quarters before the quarter ended June 30, 2016 and the financial results of the Company in the First Quarter Financials did not meet the May Projections, (ii) the sales of the Company's liquid milk products were materially below expectations of the Company for the quarter ended June 30, 2016 and July 2016, and (iii) the Company's French project, which was expected by the Company to be fully operational in the summer of 2016, had been delayed due to certain technical issues." (A161). In other words, the reasons were recent financial performance and delays to the France Facility.

Similarly, the stated reasons for lowering the August Projections were: "(i) after failing to achieve the financial results for the quarter ended June 30, 2016 reflected in the May Projections, the Company again failed to achieve the financial results for the quarter ended September 30, 2016 reflected in the August Projections, (ii) certain equipment of Synutra France International SAS, one of the Company's operating subsidiaries in France, had not yet been put into production as originally planned by the management of the Company, which adversely affected the Company's profitability and (iii) updates with respect to RMB/US dollar and RMB/Euro exchange rates." (A165). Again, the reasons were short-term financial results, and delays with the France Facility. These were merely historical issues that arguably should not have diminished the Company's future financial performance.

Despite the short term nature of these setbacks, management dramatically lowered the longer-term EBITDA projections for 2017 through 2020, as follows:

	2017	2018	2019	2020
May EBITDA Projections	$78.8	$90.1	$108.0	$130.2
August EBITDA Projections	$64.4	$78.4	$93.4	$121.1
Company EBITDA Projections	$50.3	$75.3	$89.0	$117.9

While management was justifying the lowered projections to the Special Committee with recent quarterly financial results, the Company continued to publicly tout its French Facility as a driver for strong growth going forward. (A059). And while Defendants explain that Houlihan Lokey did not use the EBTIDA projections for fiscal year 2017 in certain valuation analyses because, in light of the French Facility delays, "Company management does not feel the current fiscal year results are representative of the Company's future earnings potential," Houlihan Lokey and the Special Committee acceded to the lowering of the outer year projections based in part on delays relating to the French facility. Answering Br. at 29.

In fact, Synutra had publicly stated that "the Company remain[ed] optimistic about its prospects for continued strong growth above the industry average for fiscal 2017 and beyond, once its French facility is fully operational." (A059.) That French Facility came online and was operational as of September 2016. (A081.) Moreover, China was undergoing regulatory changes at the time that were expected to benefit the Company. (A081-82.) Nevertheless, the Company's management continued to depress the financial projections after that point. (A080.) This obvious contradiction demonstrates the Special Committee's gross negligence in failing to question or push back against the repeated downward revisions of the financial projections (which were specially prepared for this process by management beholden to the Buyout Group).

At the pleading stage, Plaintiff is entitled to reasonable inferences in his favor. *See Allied Capital*, 910 A.2d at 1030. This pattern of lowering the projections should have "carrie[d] some weight," as the trial court recognized. That weight should have led to an inference of gross negligence on the part of the Special Committee. (Or. ¶10b.)

B. The Special Committee Knew That The Company's Share Price Was Depressed And Not Reflective Of The Company's Value

The issue is not whether Zhang's deliberate depression of the Company's stock price bears on the Special Committee's gross negligence. Rather, the issue is that the Special Committee was well aware that the Company's stock price was depressed based on repeated announcements of setbacks, delays, and increased costs.

Defendants set forth a number of occasions where the Company announced financial results after the Initial Offer Letter, and indicated that it failed to meet projections. Answering Br. at 10. While the Special Committee was undoubtedly aware of these setbacks, it also had the knowledge as discussed *infra* that these short-term financial results and delays to the France facility were temporary. Thus, they knew that the stock price was depressed, and that it was thus a bad time to even discuss selling the Company. In proceeding to sell the Company anyway, the Special Committee was grossly negligent.

C. The Special Committee's Tacit Acceptance Of Houlihan Lokey's Flawed Analyses Support Allegations of Gross Negligence

As pertains to Houlihan Lokey's financial analyses, Plaintiff's allegations do not set forth a mere "disagreement with a financial advisor's valuation or methodology," as Defendants argue. Answering Br. at 34. Rather, Plaintiff alleged serious concerns with Houlihan Lokey's valuation of the Company, namely that Houlihan Lokey assumed an unreasonable, baseless capital structure that bore no resemblance to the Company's reality. Opening Br. at 31. In accepting Houlihan Lokey's fairness opinion and the valuation analyses supporting it, the

Special Committee knowingly embraced these fundamentally unreasonable assumptions and breached its duty of care.

Plaintiff's reliance on post-trial analyses of valuation disputes is appropriate here to support his contention that Houlihan Lokey's methodologies were seriously flawed, and the Special Committee's acceptance of these inputs was a breach of the duty of care. The members of the Special Committee, as Board members, should have understood the capital structure of the Company. There is no indication that they ever questioned Houlihan Lokey's baseless weighting of debt and equity, and its impact on the financial analyses. While the Special Committee was entitled to reasonably rely on its financial advisor, its failure to question such an extreme departure from reality goes well beyond the scope of reasonability. *See In re Emerging Communs., Inc. S'holders Litig.*, 2004 WL 1305745, at *39-40 (Del. Ch. May 3, 2004) (finding a director liable for failing to act in good faith when that director had "strong reasons to believe" that the merger consideration was unfair notwithstanding Houlihan Lokey's fairness opinion).

This baseless assumed capital structure led to a wildly inflated discount rate, and a substantial undervaluation of the Company. Defendants knew this – or at minimum should have known this – and were grossly negligent in accepting the fairness opinion despite the dubious inputs to the financial analyses.

CONCLUSION

The trial court's ruling contravenes the precedent articulated by this Court in *M&F Worldwide*. Appellant respectfully requests that the Court reverse the trial court's decision.

Dated: May 31, 2018

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