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Delaware Court of Chancery Declines to Apply *Corwin* to Dismiss Post-Merger Claims Against Directors in Stockholder-Approved Merger

In a recent decision in *In re Saba Software, Inc. Stockholder Litigation*, the Delaware Court of Chancery demonstrated the limits of the application of the business judgment rule under *Corwin* v. *KKR Financial Holdings LLC* (discussed here). The Court held that the target stockholder vote approving an all-cash merger with a third party buyer was coerced and not fully informed, and therefore did not "cleanse" the transaction and invoke the application of the business judgment rule. *Saba*, though decided on unique facts, demonstrates the limits of the *Corwin* doctrine following a line of recent decisions where the Court applied *Corwin* to dismiss stockholder challenges to third party mergers.

Background

The case involved Saba Software, Inc., a company with an Indian subsidiary that engaged in financial fraud from 2008 to 2012, causing the company to overstate its pretax earnings from 2007 to 2011. After the fraud was uncovered, Saba repeatedly assured its stockholders, regulators and the market that it would restate its financial statements. After multiple failures to do so, however, NASDAQ delisted the shares in June 2013, leaving Saba's stock to trade over-the-counter.

In September 2014, Saba reached a settlement with the SEC regarding its financial fraud pursuant to which Saba was required to restate its financials and file an annual report by February 15, 2015 or else its stock would be deregistered. Shortly following the settlement, Saba's stock was trading at $14.08 per share.

Saba had been exploring strategic alternatives since at least 2001 and had retained a banker to assist in the process. In November 2014, a private equity firm submitted an oral indication of interest at $11 per share. At a board meeting that same month, Saba's banker informed the board that of eleven potential buyers, only that firm had submitted an indication of interest. At that same meeting, the board formed an ad hoc committee to continue exploring strategic alternatives for the company.

On December 15, 2014, Saba announced that it would be unable to meet its deadline for restatement and its stock price fell from $13.49 to $8.75 per share. Thereafter, the board directed its banker to contact additional parties, and, the ad hoc committee was informed of a Saba stockholder that might be willing to provide additional funding to allow the company to continue on a standalone basis, as well as a group of stockholders that indicated they would be willing to do a transaction at a level above the $8 to $9 range then proposed by the private equity firm. There was no indication that the committee followed up with these parties.

By January 2015, several other third parties expressed an interest in the company, including Vector Capital Management, L.P., who had previously provided debt financing to Saba. Vector confirmed its $9 per share offer in early February after completing its due diligence and at a time when the OTC closing price of Saba's stock was $9.45 per share. After some negotiation, the ad hoc committee agreed to an exclusivity agreement with Vector at $9 per share, set to expire in six days. One day before the exclusivity agreement expired, the board met to receive the fairness opinion, which, at the board's instruction, was based on a set of management projections that assumed deregistration and that the restatement would not occur until August or December 2015. At this meeting, the board approved the merger with Vector at $9 per share, and also granted themselves equity awards that would be cashed out upon consummation of the merger in place of unvested, suspended, lapsed or cancelled equity awards.

The next day (five days before the SEC restatement deadline), Saba and Vector executed the merger agreement at $9 per share, which was a 2% discount to the average stock price for the week prior to the announcement. When the restatement failed to occur by the deadline, the SEC deregistered the Saba stock, rendering it essentially illiquid. Because of the deregistration, Saba was not required to submit its proxy or GAAP financials to the SEC for review, and therefore, was able to mail its proxy to stockholders and hold a stockholder vote on the merger on an accelerated timeframe, with the stockholder vote occurring only 44 days after announcing the merger. The stockholders approved the merger, and it closed four days later. Plaintiff, a former Saba stockholder, asserted breach of fiduciary duty claims against the board of directors (which included the CEO) and an aiding-and-abetting claim against Vector and its affiliates.

Analysis

The Court of Chancery's key holdings are as follows:

- The Court determined that the stockholder vote on the merger was not fully informed or uncoerced, and therefore, it did not operate to "cleanse" the merger and invoke the application of the business judgment standard of review under *Corwin*. As such, the Court held that enhanced scrutiny under *Revlon* would apply to the merger. In reaching this conclusion, the Court made the following findings:
  - The proxy's failure to disclose information regarding the factual circumstances surrounding Saba's failure to complete the restatement was a material omission. Without this information, stockholders would have no means of evaluating whether to accept the merger consideration that reflected the depressed value caused by Saba's regulatory non-compliance or allow the company to continue on a standalone basis with hopes of being relisted. In addition, management's

projections assumed that the company would complete the restatement at some point in the future. Without a means to test that assumption, stockholders could not assess the credibility of the management projections.

- That the proxy failed to disclose post-deregistration options available to Saba was a material omission. While in the typical case disclosure regarding the "panoply of possible alternatives" to the proposed transaction is not required, here, the deregistration caused a fundamental change to the value of the stockholder's equity and drastically altered the environment of the sales process. Thus the board was required to take extra care to account for this dynamic in its disclosures. Moreover, in order to understand whether Saba was viable as a going-concern without the proposed merger, a reasonable stockholder would need to understand alternatives available to the company.

- The failure to disclose management projections for certain years and as to certain metrics did not amount to a material omission. The Court concluded that plaintiffs' claims failed to prove that these projections existed or that they amounted merely to "why" or "tell me more" disclosure claims, which the Court routinely rejects.

- The failure to disclose information relating to the banker's valuation of Saba and details of the particular services the banker provided to Vector in the last two years were not material omissions. Plaintiff failed to show that the omitted valuation information would significantly alter the "total mix" of information that stockholders received, and therefore it was immaterial. With regard to the alleged omissions regarding details of the banker's services to Vector, the Court concluded that the proxy's disclosure that the banker or its affiliates provided "financing services" to an affiliate of Vector and received "customary fees of approximate[ly] $1 million in connection with those services" was sufficient.

- The stockholder vote on the merger was coerced, with stockholders forced to decide between keeping their recently de-registered, illiquid stock or accepting a price in the merger that was depressed by the company's failure to restate its financials. To be uncoercive, the vote must have been structured in a way that allows a "free choice between maintaining their current status [or] taking advantage of the new status offered by" the merger. The Court found, however, the stockholders did not have such a free choice, given the forced timing of the merger and the lack of information about the circumstances surrounding the company's failure to restate its financials and information regarding financing alternatives that allow Saba to remain a standalone company. As such, stockholders were left with no practical alternative but to vote in favor of the merger.

- The individual defendants were not exculpated by the Section 102(b)(7) provision in Saba's certificate of incorporation because such provisions do not insulate directors from claims of bad faith or breaches of the duty of loyalty. Here, the Court found that the plaintiff pled adequate facts to justify a pleading-stage inference of bad faith, including that the board rushed the sales process, refused to consider alternatives to a sale, cashed in worthless equity awards before the merger and directed the banker to rely on pessimistic projections. Similarly, the Court found that the plaintiff pled sufficient facts to overcome a motion to dismiss duty of loyalty claims against the individual defendants through allegations that they secured for themselves material personal benefits in connection with the merger.

- As to Vector, the plaintiff failed to plead knowing participation in the underlying breach of fiduciary duty, a necessary element to a claim of aiding and abetting a breach of fiduciary duty. The Court observed that allegations as to the receipt of confidential information, as well as conclusory allegations that a third party received "too good of a deal," without more, are insufficient to state a claim for aiding and abetting a breach of fiduciary duty. Therefore the Court dismissed the aiding-and-abetting claims against Vector.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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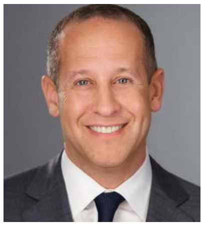

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