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CORPORATE GOVERNANCE

The Delaware Supreme Court Provides Guidance on Directors' Fiduciary Duty of Disclosure

In reversing a Court of Chancery decision, the Delaware Supreme Court has provided a reminder that while Delaware law gives significant weight to the stockholders' expression of their will, it is only to the extent that decision is made on a fully informed basis.

By John Mark Zeberkiewicz and Stephanie Norman

In *Appel v. Berkman*,[1] the Delaware Supreme Court reversed the Delaware Court of Chancery's dismissal of claims relating to the merger of Diamond Resorts International, Inc. ("Diamond"),[2] finding that the stockholders of Diamond were not fully informed when they tendered their shares in a first-step tender offer followed by a back-end merger under Section 251(h) of the Delaware General Corporation Law (DGCL). In reversing the Chancery Court, the Supreme Court held that Diamond's failure to disclose the specific reasons for which its founder and chairman had abstained from approving the transaction rendered the disclosure document materially misleading.

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Background

In early 2016, Diamond commenced a process to review its strategic alternatives, establishing a strategic review committee to oversee that effort. In April 2016, at the first stage of the process, Diamond received indications of interest ranging from $23 to $33 per share. Over the ensuing weeks, Diamond's management conducted due diligence with potential bidders, leading ultimately to a bid from Apollo Global Management LLC of $30.25 per share. In late June, Diamond's board met to consider Apollo's bid. In the two meetings

of Diamond's board leading to its approval of the transaction, Stephen Cloobeck, Diamond's founder and chairman as well as its largest stockholder, indicated that he was not supportive of the transaction. The minutes of those board meetings reflected his disappointment with the price (including his disappointment with the management team for failing to operate the business in such a manner to command a higher price) as well as his view that it was not the appropriate time to sell Diamond. On that basis, he abstained from voting for the transaction.[3]

"Delaware law does not require 'that individual directors state . . . the grounds of their judgment for or against a proposed shareholder action.'"

After the transaction was announced, but before its consummation, the plaintiff made a demand to inspect Diamond's books and records under Section 220 of the DGCL, giving it access to, among other things, minutes of meetings of the Diamond board. On September 2, 2016, Apollo acquired Diamond for $30.25 per share pursuant to a tender offer in which more than 80 percent of Diamond's shares were tendered for purchase followed by a merger without a vote of stockholders under Section 251(h) of the DGCL.[4] Two months later, the plaintiff brought suit challenging the process that the Diamond board and Stephen Cloobeck followed in negotiating and approving the transaction and alleging that Diamond's board failed to disclose all material information to stockholders with respect to the transaction.[5]

The Chancery Court's Opinion

The director-defendants and Mr. Cloobeck (as a director and as chairman) moved to dismiss plaintiff's claims, arguing that, since the holders of a majority of Diamond's outstanding shares had tendered their shares in the offer on a fully informed and uncoerced basis, the transaction was subject to review under the deferential business judgment rule.[6] Pointing to the Delaware Supreme Court's holding in *Corwin*, the Chancery Court noted that, "'when a transaction not subject to the entire fairness standard'" ab initio, as was the case with the acquisition of Diamond, '"is approved by a fully informed, uncoerced vote of the disinterested stockholders,'" the stockholders' vote has the effect of restoring the presumption business judgment rule.[7] The Court further reviewed its own precedent to the effect that, in the context of a two-step transaction under Section 251(h), the stockholders' tendering of their shares into a first-step tender offer has the same effect as a vote at a meeting.[8]

Directors have a fiduciary duty to disclose all information material to the stockholders' decision.

Under *Corwin*, once the presumption of the business judgment rule has been restored, the plaintiff's price and process claims will be dismissed unless it is able to show that the transaction constituted waste.[9] In order to avoid dismissal under *Corwin*, a plaintiff challenging a transaction must show that the vote or tender, as the case may be, was not fully informed (in the sense that the stockholders were not apprised of all information material to their decision whether to vote their shares in favor of the transaction or tender their shares in the offer, as applicable) or was coerced (in the sense that the stockholders' decision was not based solely on the merits of the transaction and there were no exogenous factors effectively driving their decision whether to vote or tender their shares in a particular manner).[10]

As more than 80 percent of Diamond's outstanding shares had been tendered in the offer and the

plaintiff had pled neither waste nor coercion, the plaintiff could only avoid a dismissal of his claims by showing that the stockholders' decision whether to tender was not made on a fully informed basis.[11] To that end, the Chancery Court addressed the plaintiff's principal disclosure claim—namely, that Diamond's Schedule 14D–9 omitted disclosure regarding the reasons underlying Mr. Cloobeck's alleged "disappointment" with the transaction's process and the ultimate price[12]—which claim hinged almost entirely on the Chancery Court's 1992 opinion in *Gilmartin v. Adobe Resources Corp*.[13] In *Gilmartin*, the Court found that the proxy statement was materially misleading to the extent it conveyed to the target preferred stockholders that the merger consideration they were to receive was fair

> without an additional simultaneous, "tempering disclosure" that two of the target corporation's directors believed that it was the wrong time to sell and had expressed that view to their fellow directors. That those two directors were also the target corporation's two most senior executives would have, according to the *Gilmartin* Court, given the omitted disclosure "heightened credibility.[14]

While recognizing the *Gilmartin* Court's opinion, the Chancery Court in *Appel* decided instead to follow more recent precedent suggesting that the omitted facts were not material. Specifically, the Chancery Court cited *Newman v. Warren* for the proposition that "Delaware law does not require 'that individual directors state (or the corporation state for them) the grounds of their judgment for or against a proposed shareholder action.'"[15] and catalogued the numerous opinions that followed the *Newman* Court's reasoning.[16] The Chancery Court found that the Schedule 14D–9 had accurately summarized the Diamond board's action with respect to the approval of the transaction, noting that it expressly stated that Mr. Cloobeck had abstained from voting for the transaction and clearly disclosed that he had not determined whether to tender his shares. The Chancery Court then noted that the plaintiff had not pointed to an instance in which the Schedule 14D–9 inaccurately characterized Mr. Cloobeck's vote or his intentions. Ultimately, the Chancery Court stated that the plaintiff had not persuaded it that the reasons for Mr. Cloobeck's abstention were material, given "the significant weight of twenty-five years of Delaware authority."[17]

The Supreme Court's Reversal

In its opinion reversing the lower court, the Supreme Court stated that the "sole issue" on appeal was whether the Chancery Court's ruling rejecting plaintiff's disclosure-based claims surrounding the basis for Mr. Cloobeck's abstention, along with its related ruling that the stockholders' overwhelming support of the tender offer restored the presumption of the business judgment rule, was correct.[18] The Supreme Court indicated that, as a result of *Corwin* and its progeny, the Delaware courts will give significant deference to the will of stockholders, but only to the extent the stockholders' decisions are made on a fully informed basis. In the Supreme Court's view, in light of Mr. Cloobeck's role as the founder and chairman of Diamond, his

> views regarding the wisdom of selling the company were ones that reasonable stockholders would have found material in deciding whether to vote for the merger or seek appraisal, and the failure to disclose them rendered the facts that were disclosed misleadingly incomplete.[19]

The Supreme Court's analysis proceeded from the basic premise that, whenever they are seeking or recommending stockholder action, directors have a fiduciary duty to disclose all information material to the stockholders' decision. It then recited the familiar test that information is material if there is a

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"substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote" and that "disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the total mix of information made available."[20]

In holding that the omitted disclosure was material, the Supreme Court rejected defendants' argument that Mr. Cloobeck's views as to the appropriate time to sell Diamond were only his opinions and thus were not facts required to be disclosed.[21] The Supreme Court stated:

> proxy statements seeking approval of major transactions are filled with statements of fact about opinions, in the sense that they recount why fiduciaries and their advisors took certain actions and why they believed the transaction was in the company's best interest.[22]

The Supreme Court then cited the portions of the Schedule 14D–9 expressing the reasons for which Diamond's board supported the transaction, stating that, when viewed in light of the many factors favoring the transaction, disclosure regarding Mr. Cloobeck's concerns "would catch a reasonable stockholder's attention and 'significantly alter[] the total mix of information'" regarding the stockholders' decision. Specifically, the Supreme Court stated that the Schedule 14D–9 could have referenced —but did not—Mr. Cloobeck's views in the description of the risk factors relating to the merger, including that the stockholders would not participate in any future potential upside and that the Company's performance could exceed its forecasts. The Supreme Court found that the Schedule 14D–9's disclosure to the effect that the Diamond board's determination that the company's strategic alternatives were not as favorable as the transaction was at odds with Mr. Cloobeck's view and that the statement regarding the fairness of the price stockholders would receive for tendering their shares, without "'additional simultaneous, tempering disclosure'" regarding Cloobeck's reasons for abstaining, was materially misleading.

Although citing favorably to the Chancery Court's opinion in *Gilmartin*, the Supreme Court did not purport to overturn *Newman* or its progeny. The Supreme Court expressly rejected any reading of *Newman* that would suggest that a director's basis for abstaining or dissenting from a decision could never be material,[23] indicating that any such reading would subvert basic fiduciary principles, given that stockholders are entitled to rely on the views of the fiduciaries they have elected to serve their interests.[24] Nevertheless, the Supreme Court recognized that, as is often the case in any review of fiduciary conduct, there is little sense in adopting *per se* rules. Thus, while it declined to hold that a director's opinions or bases for rejecting or abstaining from a decision could never be material, it likewise found that the omission of that information would not always be material. Instead, the Court reiterated that it would "adhere to the contextual approach that has long been Delaware law," requiring inquiry into whether the statement or omission of a fact would affect the total mix of information, or whether additional disclosure would be required to ensure that the other disclosures are not materially misleading.

Stockholders are entitled to rely on the views of the fiduciaries they have elected to serve their interests.

As the Chancery Court's dismissal of the claim was based on its finding that Diamond stockholders had tendered their shares on a fully informed, uncoerced basis, the Supreme Court's holding that the Schedule 14D–9 was materially misleading precluded the *Corwin*-based invocation of the business judgment rule, resulting in the case being remanded for further proceedings.

Conclusion

In providing for the business judgment rule to apply to third-party merger transactions that are

approved by fully informed, uncoerced and disinterested stockholders (whether through a vote or a tender of their shares), Delaware law gives significant weight to the stockholders' expression of their will. The Supreme Court's opinion in *Appel* serves as a reminder that the Delaware courts will defer to the stockholders' decision regarding their own fate only to the extent that decision is made on a fully informed basis. Under Delaware law, there are no bright-line rules regarding whether a particular fact is material. Rather, corporations and practitioners must consider the materiality of any fact in light of the particular context in which it arises and in light of Delaware's common law.[25]

Notes

1. *Appel v. Berkman*, — A.3d —, 2018 WL 947893 (Del. Feb. 20, 2018).
2. *Appel v. Berkman*, 2017 WL 6016571 (Del. Ch. July 13, 2017).
3. *Appel*, 2018 WL 947893, at *1.
4. *Appel*, 2017 WL 6016571, at *1.
5. *Id*.
6. *Id*.
7. *Id*. (citing *Corwin v. KKR Financial Holdings LLC*, 125 A.3d 304, 309 (Del. 2015)).
8. *Appel*, 2017 WL 6016571, at *1 (*citing In re Volcano Corp. S'holder Litigation*, 143 A.3d 727, 747 (Del. Ch. 2016), for the proposition that the same public policy underpinning the holding in *Corwin* recognizing the cleansing effect of a fully informed, uncoerced vote of stockholders applied in the context of a two-step transaction under Section 251(h), where the stockholders' tendering of their shares serves effectively serves as the manifestation of their approval of the transaction).
9. *Singh v. Attenborough*, 137 A.3d 151, 151–52 (Del. 2016).
10. *See Sciabacucchi v. Liberty Broadband Corp*., 2017 WL 2352152, at *15 (Del. Ch. May 31, 2017). In *In re Saba Software, Inc. Stockholder Litigation*, 2017 WL 1201108 (Del. Ch. Mar. 31, 2017), the Court identified circumstances under which a vote would be found not to be uncoerced for purposes of *Corwin*'s cleansing effect. In that case, a few years before its acquisition, Saba Software, Inc., through two of its former executives, had engaged in a fraudulent scheme to overstate its earnings. As a result, the Securities and Exchange Commission (SEC) required it to restate its financial statements. Despite providing the SEC repeated assurances that it would do so, Saba failed to effect the restatement, which led ultimately to its delisting. When faced with the decision whether to approve the merger at $9 per share, which was well below historical averages, or continue to hold shares that, due to the delisting, had become illiquid, the stockholders approved the merger. Due to the impact of the delisting on the stockholders' decision, the Court found that the plaintiff had pled facts allowing a reasonable inference that the vote was not uncoerced and, accordingly, refused to allow the invocation of the business judgment rule under *Corwin* and allowed the plaintiff's claims to proceed. *Id*. at *1.
11. *Appel*, 2017 WL 6016571, at *2.
12. *Id*. The plaintiff also made allegations regarding the disclosure surrounding Diamond's financial advisor, including with respect to its relationships with the buyer, as well as a Diamond board member with ties to the buyer. The *Appel* Court dispensed with those claims, and they were not addressed by the Supreme Court in its opinion on appeal. *See Appel*, 2018 WL 947893.
13. 1992 WL 71510 (Del. Ch. Apr. 6, 1992).
14. *Id*.
15. *Appel*, 2017 WL 6016571, at *2. (citing *Newman v. Warren*, 684 A.2d 1239, 1246 (Del. Ch. 1996)).
16. The Court in *Appel* cited the following opinions as ones adopting the reasoning in *Newman: In re Williams Cos., Inc. S'holder Litig*., 2016 WL 197177, at *2 (Del. Ch. Jan. 13, 2016); *Dias v. Purches*, 2012 WL 4503174, at *9 (Del. Ch. Oct. 1, 2012); *In re Sauer–Danfoss Inc. S'holders Litig*., 65 A.3d 1116, 1130 (Del. Ch. 2011). *See Appel*, WL 2017 6016571, at *2. The Chancery Court cited *Huff Energy Fund, L.P. v. Gershen*, 2016 WL 5462958, at *15 (Del. Ch. Sept. 29, 2016), for the proposition that the *Newman* Court's reasoning was extended to apply to directors' abstentions from voting.
17. *Appel*, 2017 WL 6016571, at *2.
18. *Appel*, 2018 WL 947893, at *1.
19. *Id*. In this regard, the Supreme Court noted that in Diamond's most recent proxy statement it had stated that Mr. Cloobeck has a "unique understanding of the

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opportunities and challenges that we face and ... in-depth knowledge about our business, including our customers, operations, key business drivers and long-term growth strategies, derived from his 30 years of experience in the vacation ownership industry and his service as our founder and former Chief Executive Officer." Id. at *3.

20. *Id*. at *3.
21. *Id*. at *4.
22. *Id*.
23. *Id*. at *5.
24. *Id*. In expressing its view, the Supreme Court also made the following observation that illustrates its views of corporate governance generally: "Accepting the notion that board disclosures should portray boards of directors as monolithic bastions of groupthink, within which no good faith back-and-forth occurs and no differences of opinion about important issues exists, would do little to breed respect for director decision-making. And it would adopt a vision of stockholders as immature and incapable of considering the pros and cons involved in important transactions. Full and fair disclosure involves giving stockholders a picture that is materially accurate, and in which the imperfections and inconsistencies are not airbrushed away."
25. Although focused primarily on the disclosure of fairness opinions, the following articles provide an overview of the basic principles of Delaware's fiduciary-duty based disclosure regime: Blake Rohrbacher & John Mark Zeberkiewicz, *Fair Summary: Delaware's Framework for Disclosure of Fairness Opinions*, 63 Bus. Law. 881 (2008), and Blake Rohrbacher & John Mark Zeberkiewicz, *Fair Summary II: An Update on Delaware's Disclosure Regime Regarding Fairness Opinions*, 66 Bus. Law. 943 (2011).